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Types of Business Enterprise

Structure and Control

BY

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To
H. M. C.

PREFACE

Increasing numbers of students graduating from our colleges and universities are seeking employment in big business enterprises. This must be so because little opportunity is given them for establishing themselves in business under their own names. The order of the day is "bigness" and, in most sorts of enterprise, only the bravest, or perhaps the most foolish, dare match their individual capital and wisdom against that of the masters of industry and commerce.

It would, therefore, seem logical to believe that individuals entering the employ of a present-day big business organization might go farther and faster if they have been trained to see the complete organization in its various phases in addition to the infinitesimal part with which they are immediately connected.

This volume is prepared in the hope that it may serve as a basis for training students to make the most of any opportunities which modern business may offer, that they may not only earn more but also find themselves possessed of equipment which will make their efforts a joy rather than a burden.

Should those whose schooling has not included the study of modern business organization as a background for more specific specialization find any value in reading these pages, a second hope will have been fulfilled.

The author gratefully acknowledges the thanks due to those who have contributed aid and encouragement, and to those publishers who have permitted the use of excerpts from volumes published by them.

Syracuse, New York

MAURICE CONDIT CROSS

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PART I

THE SIMPLE TYPES OF ENTERPRISE

CHAPTER I

BUSINESS ENTERPRISE.

Ownership.

Under a democratic form of government there is little restriction placed upon the right of ownership. It is true that, as society has become more complex, the conduct of human affairs has been more and more subjected to government interference, and it is possible that such interference will increase in the future. But man still retains the right of ownership. A bootblack may own the tools of his business. Partners may share in the ownership of all the elements of their business. Stockholders own their proportionate shares in corporations.

This principle of ownership is valid only so long as it is protected by the government. Any requirements or restrictions enacted by this agency are justifiable, therefore, if they are within reason. Taxes, eminent domain, building restrictions, and zoning requirements are examples of government checks on free and unlimited ownership. Inasmuch as land is limited in amount, ownership in land is said to be merely the right to the use of the land. It is legitimate, however, for us to think of ownership in terms of the things owned.

The resulting confidence that the right of ownership will be protected and preserved by the government permits individuals or groups of individuals to employ their single or combined skill, energy, and capital in satisfying their human wants through a variety of systems which may be included in the term "business enterprise." Comparatively few members of society have the necessary requirements to exercise their right to own and operate their enterprise, but they, too, are indirectly protected

by the government, as employees of those who are equipped to be employers.

Ownership may be either *public* or *private*. Public or government ownership and operation of business enterprise is typified by the postal system of the United States and by municipal ownership of certain of the public utilities such as water, lighting, and transportation systems. In the main, however, private ownership is the rule in America, although local, state, and national governments keep the necessary check upon this right.

Certain social evils have been apparent under private ownership which might have been avoided under public ownership or a more rigid application of government restriction. Vast areas of natural resources have been exploited with needless waste. Thousands of investors, large and small, have been literally robbed by unscrupulous business men. But current opinion still holds the system of private ownership and operation to be more efficient and desirable in the long run. We are to be concerned, then, with the organization and control of private business enterprise and with the efforts of a democratic government to keep a check on this form of economic endeavor.

Advantages of Ownership.

Probably every individual, at some time in his life, hopes to own his own business, to "work for himself," and to employ others to work for him. There is nothing more romantic than the rise of successful business men. Harriman, Vanderbilt, Rockefeller, Carnegie, Ford, and the others have been exhibited as successful Americans and have been the envy of most individuals making up the remainder of society. The success of some of these men, such as the railroad builders, has been due to their skill at manipulation of shares of ownership, that is, corporation stocks, and they have amassed fortunes without, perhaps, rendering service equivalent to their reward. Others, like Mr. Ford, have employed a different kind of talent and their incomes have been derived directly from service rendered in the production of

desired commodities. In any case, the ownership of enterprise is seen to have marked advantages. This fact may be made more impressive by an analysis of the original organization procedure of the Ford Motor Company. In the beginning, Mr. Ford invested himself, and his car, and is now reputed to be worth \$1,000,000,000. James Couzens, later United States senator, invested \$900 in cash and \$1,500 in notes, and later sold out for \$39,500,000. His sister invested \$100 and sold for \$355,000 and would have doubled her investment and consequently her profit, but for the unfortunate advice of her father. The other original investors fared as follows:

<i>Individual</i>	<i>Investment</i>	<i>Realization</i>
Alex Y. Malcomson	\$7,000	\$175,000
Dodge Brothers	10,000 (services)	34,871,500
J. S. Gray	10,000	36,605,075
Horace Riekham	5,000	17,435,750
John Anderson	5,000	17,435,750
Albert Strelow	5,000	25,000

It is of interest to note that Mr. Malcomson's investment would be worth \$250,000,000 to-day, and Mr. Strelow's would be worth \$4,000,000 yearly income or \$50,000,000 in cash.

The tendency is usually to emphasize the profit motive in explaining why individuals assume the burden of the entrepreneur. But we may pause here to inquire why it is that, if profits constitute the chief aim of enterprise, the business world is dominated largely by business men of great wealth, who no longer need such a motive. Mr. Ford and Mr. Edison could well afford to retire on the store of accumulated wealth which they possess, but they still seem eager to advance their own interests. The answer to such an inquiry compels the introduction of additional motives.

Americans are fundamentally lovers of competition. Playing and witnessing games where the highest type of competition exists is increasingly appealing to citizens of both sexes. There can be no doubt that business men are keenly interested in playing the game of business

merely as a game. In addition, humanity courts esteem. The successful man in business may desire the admiration and, in some cases, even the fear of employees, associates, and society in general, and has, possibly, acquired the habit of cultivating the attention and obedience which he is loath to relinquish through retirement. This desire for public favor thus becomes a powerful motive or incentive to continued activity. Others have developed the acquisitive instinct to such a degree that still greater profits and funds of wealth are their chief aims, apart from or coincident with any or all of the other factors mentioned. Finally, some desire activity for activity's sake or for the purpose of retarding old age as much as possible.

Disadvantages of Ownership.

Despite these seeming advantages, the great majority of people are employees rather than employers. It is possible to observe quite accurately why this is so by inquiring into the causes which make ownership and operation of enterprise difficult of attainment. They may be summed up as follows:

1. Risk. 2. Responsibility. 3. Inexperience and Incompetence. 4. Inertia. 5. Lack of Capital.

Risk.—It is obviously impossible to indicate with any degree of accuracy the exact part which each of the above factors play in reducing the amount of ownership of business enterprise. But it is quite safe to assume that the risk involved is no small factor in weighing the advisability of deserting the ranks of the worker for those of the capitalist. Some have been willing to venture an opinion that 90 per cent of those who go into business for themselves fail ultimately. Thus, even if one possesses the required capital, skill, energy, and leadership he still is influenced by the inhibitory effect of his risk element. And if he has capital without the other necessary qualifications, this inhibitory influence reacts more emphatically. The small purchaser of stock in a corporation buys or refuses to buy largely because of the absence or presence of risk.

Risk may or may not be proportionate to the expected gain. Some enterprises have required small investments and consequently little financial risk and have proved to be extremely profitable. Others, like the National Cash Register Company, have yielded high profits only after encountering seemingly insurmountable obstacles. But wherever keen competition exists, or whenever an enterprise can be affected by the success or failure of other enterprises as is the automobile accessory manufacturing enterprise, the element of risk becomes highly significant. This fact was illustrated in the Spring of 1924 when certain automobile concerns curtailed production, having produced during the previous winter more cars than the trade could absorb. Manufacturers of parts and accessories were in turn forced to reduce their activities, and this reduction was passed on to the vendors of raw materials, and so on indefinitely. The effect of such a condition of affairs is, therefore, reflected in a large number of organizations.

The necessity for establishing credit policies affords another risk. It is estimated that nearly 2 per cent of the failures are due to unwise credit policies.¹ Fraud, another risk, according to the same estimate, accounted for 4.2 per cent of the failures. Other sources of risk might be listed, but sufficient has been said to indicate the significance of risk as a restraining influence on business enterprise.

Responsibility.—Perhaps in a large number of cases responsibility is a part of risk. However, some entrepreneurs surrender all advantages of ownership purely to avoid unpleasant responsibility. For example, a prominent grocer in a Middle Western city sold his business to a purchaser, stipulating at the time of sale that the new owner was to employ him as a clerk. A similar instance has been observed in an Ohio city barber shop. This desire to avoid the burden of ownership has, in numerous cases, an inhibitory effect on entrepreneurship. This fact may be substantiated by careful observation and

¹ "Failure Statistics, Their Meaning and Utility," *Bradstreet* (1923).

analysis of the causes of the excess of employees over employers.

Inexperience and incompetence.—Many individuals possess the ambition and boldness necessary to success in business enterprise but are compelled to serve an apprenticeship, as it were, before succeeding in an undertaking. Thus the number fitted to enter the ranks of the entrepreneurs is cut to a smaller proportion. Some recognize this limitation and set themselves to the task of learning the business before embarking upon their venture. Others, being more venturesome, or less wise, invest their energies and capital and are compelled to return, through failure, to the employee class—to remain, or to emulate their wiser contemporaries. Inexperience and incompetence have caused more than one-third of the business failures in the United States.² This factor may be of greater or lesser importance than indicated by this percentage, but certainly it is an important factor in deterring individuals from entering into business for themselves.

Inertia.—The tendency on the part of individuals to maintain the *status quo* may be called inertia. To put it another way, it seems to be a human trait to get into a rut and to stay there. The college professor, for example, could always secure a larger income somewhere else or in some other line of effort, yet for some reason or other he refuses to desert his books and his pleasant environment. It would be absurd to assume that the farmer with his broad shoulders and strong muscles is doomed to be a farmer because he can do nothing else. And yet the “dyed-in-the-wool” farmer has tended to remain on the farm, at least until recently. Or, as a laborer puts it:

“It is the life that gives the most freedom and the least responsibility. I can do work with my muscles that brings me forty-five dollars a week, and while I work, my thoughts can rove about the world, for they are not hired by my employer; they are free. I can feel a pride and

² *Ibid.*

physical pleasure in the performance of such work. I enjoy the comradeship of unpretentious men. I prefer girls who are happy in a kitchen and who are glad to ride in a flivver or trot out on a public dance floor. I like to sleep sound and eat hearty. I like to live where I can read either Balzac or Bugs Baer without discussing them. I like to live as far as possible from the influence of the self-appointed leaders, uplifters, and saviors of poor old humanity. I can come nearer finding the life I like as a laborer than at any other occupation.”³

With due respect to the college professor, the farmer and the laborer, the term inertia applies also to the type of person commonly called lazy, as he, too, is satisfied with his lot. Thus, it becomes evident that it is only the exceptional individual who successfully steps out into entrepreneurship.

Lack of capital.—Most people lack capital with which to enter business. It may be safely estimated that more than one-third of business failures may be attributed to lack of capital. Even if we assume a large group equipped with all other qualifications for successful business men, it is obvious that, lacking capital, most people must remain content to assume a less powerful position, individually, in the business world.

Variety of Business Requirements.

Society demands a large variety of products and services which may be classed as either luxuries or necessities. A knowledge of the nature, intensity, and continuity of the social demand for the production of the services or commodities is essential before forming a decision or making a choice as to what to produce. In some lines, the market may be nearing the saturation point, or may already have reached it. The undertaking may be conceived when times are prosperous or when a general depression becomes current. The product or service may be feasible but may require an extended campaign of

³ Anonymous, *Saturday Evening Post*, June 7, 1924. (Reprinted by permission.)

education through advertising. Competition may be exceedingly keen. For these and other reasons, the exercise of great care in the choice of a product, whether service or commodity, as well as in the choice of the type of enterprise to be adopted, is essential.

Types of Business Enterprise.

The difficulties just enumerated have led to efforts on the part of those who would organize business undertakings to reduce the element of risk to a minimum or to insure a maximum of safety. As a result, there now exists a large variety of types of enterprise ranging from a high degree of simplicity to a high degree of complexity. In fact, a business enterprise may be defined as *an effort to combine the factors of production—land, labor, and capital—in such a way as to secure the highest possible net profit with a minimum waste of the productive factors*. These types may now be classified as follows:

I. Basic Types:

1. Sole ownership.
2. Partnership:
 - (a) General.
 - (b) Limited.
3. Partnership association.
4. Corporation.
5. Joint stock company.
6. Massachusetts trust.

II. Types involving inter-relationship:

1. Pools and agreements.
2. Community of interest.
3. Consolidation:
 - (a) Merger.
 - (b) Amalgamation.
4. Sale of assets.
5. Trusts.
6. Holding company.

The majority of business organizations are sole proprietorships or partnerships. But the corporate form has

become increasingly important. This fact is shown in the following table of manufacturing industries only:⁴

ESTABLISHMENTS, WAGE EARNERS, AND VALUE OF PRODUCTS,
BY CHARACTER OF OWNERSHIP: 1904 TO 1919 *

CHARACTER OF OWNERSHIP	ESTABLISHMENTS		WAGE EARNERS		VALUE OF PRODUCTS	
	Number	Per cent distri- bution	Number	Per cent distri- bution	Amount in millions	Per cent distri- bution
ALL CLASSES:						
1904	216,180	100.0	5,468,883	100.0	\$14,794	100.0
1909	268,491	100.0	6,615,046	100.0	20,672	100.0
1914	275,791	100.0	7,036,247	100.0	24,246	100.0
1919	290,105	100.0	9,096,372	100.0	62,418	100.0
INDIVIDUALS:						
1904	113,946	52.7	755,923	13.8	1,703	11.5
1909	140,605	52.4	804,883	12.2	2,042	9.9
1914	142,436	51.6	707,568	10.1	1,925	7.9
1919	138,112	47.6	623,469	6.9	3,536	5.7
CORPORATIONS:						
1904	51,097	23.6	3,862,698	70.6	10,904	73.7
1909	69,501	25.9	5,002,393	75.6	16,341	79.0
1914	78,152	28.3	5,649,891	80.3	20,183	83.2
1919	91,517	31.5	7,875,132	86.6	54,745	87.7
ALL OTHER:						
1904	51,137	23.7	849,762	15.5	2,187	14.8
1909	58,385	21.7	807,770	12.2	2,289	11.1
1914	55,203	20.0	678,788	9.6	2,138	8.8
1919	60,476	20.8	597,771	6.6	4,137	6.6

* Later figures are not available as this book goes to press.

The earliest census to inquire into the character of ownership was that of 1900. At that time there were 37,123 establishments in the country operated by corporations, representing 17.9 per cent of the total number of establishments. Inasmuch, however, as the census of 1900 included neighborhood industries and hand trades, these figures are not closely comparable with those shown for later censuses, from which such industries and trades

⁴ Abstract of the Census of Manufactures, 1919, p. 340. (1923.)

were omitted. The data for the censuses since that of 1900 are given above.

Ownership prior to 1914 was reported under four headings, "Individuals," "Corporations," "Firms," and "All others." For the purpose of this study the last two classes are combined. The group "All others," therefore, is made up chiefly of establishments operated by firms, but includes co-operative associations and miscellaneous forms of ownership that could not be classed as "individuals" or as "corporations." As can be seen from the table, the greatest number of establishments are operated by individuals, although corporations have increased from 23.6 per cent of the total number in 1904 to 31.5 per cent in 1919. This growth in the proportion of corporations was quite regular throughout the period, and thus far has given no signs of diminution.

The most significant figures, however, are those which show the extent of the industrial activity of the corporations. Although including only 31.5 per cent of the establishments, they employed 86.6 per cent of the wage earners and manufactured 87.7 per cent of the total value of the products.

This proportionate increase in corporation activity is due in part to the failure of the other forms to adapt themselves to the modern tendency toward bigness. This fact is reflected in the disadvantages of the other forms which will be considered in succeeding chapters.

There has been a growing disposition on the part of the state and Federal governments to bring greater pressure to bear to correct the increasing social evils of the corporate form. Whether or not these corrective measures, if adopted, would tend to retard the use of this form of organization remains to be seen. The question arises at the same time as to whether or not the demands of our present industrial and commercial systems will permit of any action which will have a tendency to reduce the use of the type of organization designed especially to satisfy modern needs. Some corrective proposals will be considered later.

The fact that such a large number of the other forms

still exist would suggest that they may have advantages not possessed by the corporation, or, conversely, that they lack some corporate disadvantages. And it may be that only those types will continue to exist which can survive the severe competition which is certain to prevail. The immediately succeeding chapters will point out the nature of the basic types, placing emphasis on the advantages and disadvantages adhering to each.

Choice of the Type of Enterprise.

The choice of the specific type of organization to be employed is based on the following factors:

I. Subjective Factors:

1. Degree of control.
2. Risk distribution.
3. Dilution of profits.

II. Objective factors:

1. Degree of government interference:
 - (a) Taxes.
 - (b) Reports.
 - (c) Other legal checks.

Subjective factors are those considered from the standpoint of advantage to the owner or owners, or to the stockholders, of any enterprise. One cannot "have his cake and eat it too," so that the problem of surrendering, delegating, or retaining prerogatives should be of considerable concern to a promoter. Obviously, a theoretically perfect condition would exist whenever control and profits were retained and risk eliminated.

The term "objective factors" is used to designate the degree of social control exercised through government agencies. It will be discovered later that such features as taxes, reports, and other legal checks materially affect some forms of enterprise, especially the corporation as such, as well as those involving intercorporate relationship.

Problems.

1. In your opinion, is government interference likely to become a more or less important consideration in business enterprise?
2. Mention other specific cases of government ownership.
3. What resources have been wastefully exploited? Would you advise government interference? Explain.
4. "To some men the wish to endow worthy causes is also a factor of importance in encouraging them to economic activity." Criticize.
5. Classify all types of business enterprise.
6. Explain each of the factors determining the choice of the type of enterprise.

CHAPTER II

THE DEVELOPMENT OF BUSINESS ENTERPRISE; THE INDIVIDUAL ENTREPRENEUR

The Beginning of American Industrial Enterprise.

In 1791 Alexander Hamilton, as Secretary of the Treasury, in obedience to an order from the House of Representatives, submitted a "Report on Manufactures." Although this document was intended primarily as a plea for a governmental policy encouraging manufacture in the United States, it gives some indication of the industrial development of the country at that time. The Revolutionary War had created, of necessity, many infant industries. Although a considerable number were unable to survive the foreign importation of goods which succeeded the artificial period of protection afforded by the war, Hamilton found 17 industries which had "grown up and flourished with a rapidity which surprises, affording an encouraging assurance of success in future attempts." In addition to these "manufactures carried on as regular trades," which included those industrial activities which one might expect to be first developed in a new country—the manufacture of agricultural implements and fire-arms, the work done by sawmills and gristmills, the dressing of skins and hides, etc.—Hamilton describes "a vast scene of household manufacturing which contributes more largely to the supply of the community than could be imagined without having made it an object of particular inquiry. It is computed in a number of districts that two-thirds, three-fourths, and even four-fifths of all the clothing of the inhabitants are made by themselves."

Reasons for tardy development of manufactures.—A similar report was called for by the House of Represen-

tatives in 1809, and in the following year Albert Gallatin, then Secretary of the Treasury, submitted a statement which has been called "an admirable summary of the condition of American manufactures at that date." The significant feature of this report is the list of reasons which Gallatin assigns for the admittedly tardy development of manufactures in the United States. They are five:

1. The abundance of land.
2. The high price of labor.
3. The scarcity of capital.
4. The preference for agriculture and commerce during the Continental War.
5. The force of tradition and habits.

But these reports submitted by the Secretaries of the Treasury were necessarily inaccurate and unsatisfactory, and it was soon realized that an adequate report could be obtained only by a special inquiry.

The census of manufactures.—The census of manufactures taken by the United States Government had its beginning in 1810, when Congress, by the act of May 1, authorized the expenditure of \$40,000 to compensate the marshals and their assistants for taking "an account of the several manufacturing establishments and manufactures within their several districts, territories, and divisions." A later act, that of May 16, 1812, authorized the expenditure of \$2,000 "to employ a person to digest and reduce" the data which became the first digest of manufactures. No copy of the schedule used in collecting the data is known to exist, but the inquiries at that census, as shown by the printed digest made by Tench Coxe in 1813, were confined apparently to the kind, quantity and value of goods manufactured.

Gallatin estimated that the value of the products of American manufactures in 1809 exceeded \$120,000,000, while Tench Coxe, in his digest of the census of 1810, sets a figure of \$198,613,471. Such figures seem small indeed as compared with those of 50 years later, which were 20 times as large, and of 100 years later, when the value of

products had multiplied considerably over 100 times.

The factory system had been introduced into this country in the later part of the eighteenth century. In 1789 Samuel Slater, called by President Jackson the "father of American manufactures," set up in Pawtucket, R. I., the first complete cotton machinery to operate in this country, constructing the machinery entirely from memory of that which he had seen in England.

Although the factory system made rapid strides in England, it developed in the United States at a much slower rate. The system really gained its first foothold during the period of embargo and the War of 1812, which was followed by the first protective tariff, that of 1816. The manufacture of cotton and wool passed rapidly from the household to the mill; but the methods of domestic and neighborhood industry, even in these lines of manufacture, continued to predominate down to and including the decade between 1820 and 1830. The rapidity with which the factory system expanded is evidenced by the growth of the cotton industry, the number of spindles in operation in Massachusetts during this period being as follows:

1830	340,000
1840	624,000
1850	1,288,000
1860	1,688,500

It was not until about 1840 that the factory method of manufacture was widely introduced in miscellaneous industries and began gradually to force from the market the hand-made products with which every community had hitherto supplied itself.

It is unfortunate that census records fail to throw any light on this period of industrial development. The manufactures census of 1820 was so defective that Congress did not authorize the publication of the figures. The enumeration of 1830 omitted the inquiry into manufactures entirely. In 1830 the census included a discussion of manufactures in a group entitled "Schedule of Mines, Agriculture, Commerce, Manufactures," but no attempt was made even to foot up the aggregate value of the prod-

ucts. Consequently, until the middle of the century, except for the year 1810, no adequate figures concerning industrial development can be found in the census reports.

Other sources of information.—There are at least three official sources, however, from which supplementary information can be drawn. These sources consist of:

1. Data on the urban and rural distribution of the population.
2. The occupational distribution of the population.
3. The issuing of patents.

Urban and rural population.—Any considerable development of manufacturing under the factory system should reflect itself in the urban and rural distribution of the population. The beginning of the nineteenth century recorded very little urban concentration. There was no marked increase up to 1820, but since that date the rate of increase has been enormous, reaching its height during the decade 1840 to 1850, but still continuing at such a rate that the end of the nineteenth century found one-third of the total population in these larger communities. It is interesting to note that the decade from 1840 to 1850 returned the highest rate, since it was approximately at that time that the factory system was being most rapidly introduced.

Occupational distribution.—It is possible to extend this study to the different occupational groups. In 1787 Tench Coxe had estimated that less than one-eighth of the population was engaged in manufacturing, fishing, navigation, and trade, a category so broad that it included nearly everything save agriculture. Unfortunately, these data are not strictly comparable, but nevertheless, they do shed some light on the situation. The data for 1820 and 1840 may be used comparatively and indicate, even at that early period, a moderate increase in the proportion of the population engaged in manufacturing. Likewise, the next two censuses, those for 1850 and 1860, furnish data which can be compared. However, the 1850 census of occupations included only males, while the 1860 census included both males and females. Since

the bulk of female labor at that time was engaged in agriculture, the inclusion of women in 1860 kept the percentage engaged in manufacturing lower than would be recorded in a strictly comparable figure. The censuses from 1870 to date are comparable and demonstrate a continual increase in the proportion of the employed group which is engaged in manufacturing and mechanical industries.

The patent system.—On April 10, 1790, because of the ardent advocacy by Thomas Jefferson, the first American patent system was founded. Records have been kept, of necessity, and, to the extent that activity in manufacturing begets technical improvements, the increase in the issuing of patents may be taken as indicating industrial development within the country. These data indicate that the period during which the invention of technical improvements was increasing at the fastest rate was from 1850 to 1870. Although this development has continued to the present time, it has been at a much slower rate. These facts bring additional evidence to justify the hypothesis that the middle of the nineteenth century saw the factory system firmly established in the United States and destined to much greater expansion, though at a somewhat slower rate.

The effect of invention and improved methods.—Certain of these changes in technique were of profound influence on industrial development. During the first third, and in some districts half, of the century, hay was cut with a scythe and grain with a sickle or cradle, and both were hand-raked; but the mowing machine, the horse rake, and the reaper appeared soon thereafter. In 1833 the first reaping machine was patented, although its use was not extensive until some time later. Threshing machines were in fairly general use by 1840, and separators by 1850. The use of steam instead of horses as a source of power for driving threshing machines began as early as 1860. The manufacture of agricultural implements was an old industry, but its nature was entirely changed by these new developments.

In the iron and steel industry also, important develop-

ments appeared. Until nearly 1840 iron was smelted only by charcoal, the process differing little from that employed in colonial times. It was not until the decade between 1830 and 1840 that puddling was generally introduced into the United States. The rails used for the construction of the early railways were made of iron and were only gradually superseded by steel rails. It is interesting to note that all the steel rails used in this country prior to 1860 were obtained by importation. Steel rails were first manufactured in the United States in that year, and the first Bessemer steel was produced in 1864.

Changes in industrial technique have occurred in nearly all industries, though with varying importance and at different times. In many cases such changes appear to be cumulative in nature. An improvement at one point in a process often stimulates development at some other point, because it demonstrates the economy resulting from technical improvement, and more especially because it upsets the customary balance within the total process, focussing attention on some step which in particular retards the total activity. The tendency toward improvement of industrial technique was clearly indicated in the figures for the issuing of patents, previously cited. It is probable that the major technical changes were made in the nineteenth century, and more and more the present-day developments take on the nature of refinements. As early as 1900 the Census Bureau reported concerning the cotton-spinning industry:

“No radical improvement has been made during the past decade in spinning machinery of either kind, nor do the makers of such machinery anticipate great changes in the future. The mule is already a perfect machine, in the sense that it is automatic in every part and that in none of the various operations which it performs without human guidance does any part act as a drag upon the others.”

Cotton-spinning was practically the first industry to introduce the use of power machinery, and it is therefore of particular interest to note that it has reached a point beyond which no further improvement is visible. In most

industries, of course, such mechanical perfection has not been attained, but the great changes in technique, particularly along the lines of applying power, began early in the nineteenth century and spread rapidly until all industries had been affected.

The Civil War and industrial development.—There was an enormous expansion of industry during the Civil War decade, as shown by the increase of 56.6 per cent in the number of wage earners. The fact that the average number of wage earners per establishment decreased during this period requires some explanation. It is to be found, not in industry, but in the nature of the census enumeration. It has been the custom of the Census Office to exclude from the list of manufacturing establishments all enterprises having a product of less than \$500 during the census year. The census of 1860, however, had failed to record many artisans whose activity entitled them to record in the census of manufactures. In the census of 1870, however, the omissions appear to have been proportionally less numerous, first, because of a general advance in prices between 1860 and 1870, bringing many enterprises which had not been recorded in 1860 incontestably above the \$500 minimum, and, second, because of stringent instructions to the assistant marshals concerning establishments of this smaller type. The addition of a considerable number of small establishments naturally resulted in a decrease in the average number of wage earners per establishment and is doubtless the explanation for the low figure of 1869.

From 1869 to 1879 practically no increase in the number of manufacturing establishments appeared. This did not seem at all strange at the time, for it was felt that the internal development of industry was the important factor. The growth of sash, door, and blind factories, of machine-made furniture factories, of a contract system of construction, and other similar forms of consolidation of enterprises, was taking place, and therefore no further increase in number of establishments was to be expected. An interesting demonstration of this tendency is quoted from the 1880 census report as follows:

“While the settled area of 1840 was but a little over one-half that of 1880, and the value of its manufactured products perhaps not more than one-seventh or one-eighth, there were almost as many gristmills at the former as at the latter date, and an even greater number of sawmills.

“The figures for the two censuses are as follows:

	1840	1880
Gristmills	23,661	24,338
Sawmills	31,650	25,708

“This fact shows strikingly the tendency to the concentration of productive industry during the past 40 years, due chiefly to the increased facilities for transportation.”

The Census of 1890 showed a further increase in all respects. This is particularly noticeable in the hand trades and in certain industries of which the census had taken no previous cognizance, such as bottling, steam-railroad repairs, china decorating, etc.

It will at once be recognized that the value of products is a function of both physical production and the price level. An increase in the figure, therefore, may be only a reflection of an increase in price level. An increase in the value of products may or may not be significant as an indication of industrial growth.

The first grave difficulty appeared in 1870, when the value of products was recorded in terms of greenback dollars, whose exchange value in gold dollars was in the ratio of 5 to 4. This deficiency was corrected, according to an estimate made by the superintendent of the census, reducing the original figures by 20 per cent, “the average premium on gold being for the 12 months—June 1, 1869, to May 31, 1870—25.3 per cent, which is closely equivalent to a discount on currency of 20 per cent.”

Correcting for the monetary unit, however, does not eliminate the factor of price fluctuations. An attempt to correct for this element was made and recorded in the census of 1870, but unfortunately the method used was not reported. “After much thought and extensive in-

quiry on the subject and the application of numerous tests, the superintendent is disposed to regard . . . the increase in manufacturing production in the 10 years to be represented by 52 per cent." The fact that no change in the value of products per establishment occurred during the decade 1859-1869 must be explained by the inclusion of many smaller establishments in the census of 1870, as discussed above.

After 1870 the price level fell until nearly the end of the century, so that the figures for value of products are, if anything, not indicative of the full extent of the increase in physical production. It is interesting to note this striking increase, however, not only as indicating enormous industrial development, but also as demonstrating the gradual concentration of industry into fewer and larger enterprises. During the last half of the century the value of products per establishment trebled, not because of price fluctuations, which were, as stated above, in the opposite direction, but rather because of improved machine methods and the development of larger units of economic enterprise.

Transition from Agriculture to Manufacturing.

During the last 50 years of the century the number of wage earners multiplied about five and one-half times, whereas the value of products increased to nearly 13 times its earlier figure. Such an inequality indicates in a very definite way the vast improvement in technique, and particularly the part played by the capital investments which appear in the factory system. It is not probable that wage earners were much more skillful as laborers in 1900 than in 1850, but with the assistance of new capital equipment they were able greatly to increase their per capita output.

There is perhaps no better method of summarizing the development than to show the shifting proportions of the three main branches of economic activity—agriculture, manufacturing, and mining. In 1850 the product of the activity of manufacturing establishments—"value added

by manufacture," in census terminology—represented but one-quarter of the total product for the three groups. Manufacturing increased at a much faster rate than agriculture, and at the close of the century the value added by manufacture had actually surpassed the total value of agricultural products. The greatest height in manufacturing yet reached was reported in 1919, when manufacturing activity yielded more than one-half of the total return for these three major economic activities. The United States entered the twentieth century a manufacturing nation. The events of the twentieth century have served only to intrench her in that position.¹

The Beginning of Modern World Industry.

As previously indicated, business organization, as such, must have as its motive—profits. Some writers have insisted that simple efforts to make a living constitute business enterprise, but it seems advisable to cling to the definition previously given. This qualification is important, for it puts a limit on the beginnings of true business organization. Certainly there can be no definite suggestion as to the beginning of profit-making enterprise as it is now known. Whatever private initiative and enterprise existed prior to the "dark ages" was largely lost through the system of feudalism existing during that period. The self-sufficiency of producing units, the absence of any means of transportation, and the danger involved in travel necessarily precluded any exchange of goods which might result in profits to the producers.

The fall of the feudalistic economic system, resulting in the rise of a free class of labor having freedom of contract, made possible individual productive efforts and the creation of exchangeable surpluses. Thus the stage was set for the arrival of the industrial revolution which further stimulated individual endeavor and made possible modern industry and commerce out of which profits arise.

¹ Adapted from "The Integration of Industrial Operation," Census Monograph III, Bureau of Census, Chapter I.

The Development of Commercial Enterprise.

While industry was thus progressing, new marketing methods were evolving under the stimulus of improved industrial, transportation and credit facilities. The public market, established in this country in Colonial days, first served as a channel through which goods found their way to the consumer. The obvious limitation upon the breadth of such markets stimulated a new method of distribution by which itinerant merchants, purchasing their stocks from the public markets, traveled abroad through the countryside selling to dwellers who were unable to visit the cities. Each of these forms still finds employment in such events as automobile shows, which are similar to the early fairs, and through such traveling agents as tea and spice companies employ.

Evolution of the store system.—The earlier stores in this country were in the nature of shops where patrons came to secure goods made to order for later delivery, as is done to-day in the "tailor shops." Here is the origin of the term "shopping" now used in a broader sense.

The general store formed another early medium for marketing goods. This type of store had its origin in the trading post which, because of its isolated position, came to carry a great variety of merchandise, continuing to do so when towns and cities began to surround it. The specialty shop, however, became the dominant market in the earlier days of American development.

These forms of domestic marketing have been largely superseded, with the modern growth of cities, by mail-order, chain, and department stores. Still more recent are the self-service stores such as the Piggly Wiggly system.

Both industry and commerce were probably carried on in the early days by single individuals. As need for larger units of enterprise became common, partnerships and corporations sprang up in order that larger funds of capital might be accumulated. The development of these forms will be traced in this and subsequent chapters.

The Contractual Relationship.

Business relationships are contractual in nature. The individual proprietor contracts with outside parties. The partners of a partnership contract with each other and with third parties. The corporate relationship is based on the contract between the state and the corporation and, as such, may in addition contract with outside parties. It follows, therefore, that only those capable of making a contract are eligible to be classed as pure entrepreneurs.

Who may make contracts?—The laws vary in the several states in the matter of eligibility to contract. But in general it may be said that power to make enforceable contracts is prohibited to:

1. Minors.
2. Mentally deficient persons.
3. Alien enemies.

By most state statutes, and under the common law, a person under the age of 21 is a minor or infant and is not eligible to contract. It may be said that the contracts entered into by minors are not void, but voidable; that is, a minor has the option of living up to his agreement during his minority and of ratifying or refusing to ratify it upon reaching his majority. Contracts for necessities, however, do not fall under this rule and consequently are enforceable at law.

Contracts entered into by insane persons are void when the insane party to the contract has been legally so declared, or may be voidable upon establishing the fact of insanity.

In general, it may be said that the right of aliens to enter into contractual relationships is the same as that of native or naturalized subjects excepting that alien enemies are prohibited from making new contracts during war periods and contracts previously made are, as a rule, suspended.

Contracts must be for a lawful purpose. When drawn so as to include purposes against the public policy such

as an immoral purpose, or for the purpose of influencing public officials by corruption, a contract is illegal. Similarly, agreements in restraint of trade are held to be illegal where unreasonably detrimental to social welfare.

Contracts may be either express, where the agreement is formed and stated either verbally or in writing, or implied, where an agreement is presumed from the acts of the parties.

In the following analyses of the various types of enterprise, considerable emphasis will be placed upon the nature of the contracts made between or among the parties comprising the personnel of the organizations. Obviously, there is no such contract in the individual entrepreneurship, and it must be studied without reference to such relationships.

Subjective Factors Affecting the Use of Individual Enterprise.

By virtue of the fact that numerous individuals elect to carry on the chosen business enterprise by themselves, it would seem that there must be some advantage in so doing. It will be remembered that in the last chapter reference was made to subjective and objective factors determining the choice of the most advantageous type of enterprise. Subjective factors were listed as:

1. Degree of control. 2. Risk distribution. 3. Dilution of profits.

Degree of control.—It has been suggested that the ideal form of enterprise would be one in which the interested party or parties could retain control and profits and eliminate risk. Where control is the dominant interest of the organizer, the individual entrepreneurship affords relief. It will be found, as an analysis of the other business forms is made, that types of enterprise depending on larger membership must surrender certain advantageous factors affecting choice of type of enterprise. In retaining entire control over the conduct of an enterprise, one must accept, as a matter of course, all of the risk which may be involved in its conduct.

Frequently individuals are temperamentally unsuited for carrying on business activities involving intimate contact with associates. It follows, therefore, that where one desires to enter business in a small way, hoping to avoid the problem of "getting along" with associates, he may find it advantageous to embrace the individual entrepreneurship. Here, the element of financial risk is counter-balanced by the risk of disagreement which would be present in a partnership. In the corporate form, this personal element is practically lost sight of.

Advantages of single control.—There are several advantages arising out of retention of complete control:

(1). Centralization of control, resulting in (2). Flexibility in policy, and (3). Secrecy.

Control may be centered in the hands of an individual; shared as in the case of the partnership; or delegated, as in the case of the corporation. Whenever more than one person becomes interested in policy determination and vested with authority, confusion arises as to what policies are to be pursued. Centralization, reducing as it does the possibility of contention, becomes an advantage not to be lightly esteemed.

Out of this attribute arises great flexibility in control in as much as the individual may, on his own initiative, adjust policies to meet changing requirements from time to time without reference to partners, as in the case of partnerships, or stockholders or directors, as would be necessary in the case of the corporation.

Disadvantage of single control.—Complete control is accompanied by the disadvantage of limitation on intelligence, genius, and experience. It seems fair to suppose that in no one man can all these attributes be combined in the proper proportion. Diversity in qualities could be artificially obtained by the introduction of a variety of individuals into the organization, each contributing some factor of value.

Perpetuity, likewise, cannot be maintained, for with the death of the owner, the single proprietorship is terminated. There is no guarantee that the heir or person

coming into possession wishes or is equipped to carry on the business, with the result that stability in business, so much desired in society, cannot be realized by the wider use of this form.

Risk distribution.—In case it becomes desirable to eliminate or reduce the risk element in order to accumulate large sources of capital to carry on larger-scale enterprises, the factor of control fades into the background in the interest of safety. In the United States, the corporate form supplies the largest degree of safety to investors, as will be seen later, while sharing both control and profits.

It may be argued that the partnership form, while dividing individual control and profits, produces the greatest degree of risk in as much as each individual partner is liable, to the amount of all his worldly goods, for any debts, contracted by any other partner, which may be presumed to have been made in the interests of the partnership.

Dilution of profits.—Retention of all of the profits necessarily requires the choice of the individual entrepreneurship. It does not necessarily follow, however, that additional partners, contributing additional capital, will reduce the individual returns, since production or trade may be increased to double the previous income, or to increase it in even larger proportion. Thus, it is shown that any determination to retain all of the profits necessarily limits the amount of capital available, and consequently forces the enterprise to assume and retain small proportions. There are some cases, such as that of the Ford Motors organization, which seem to refute this statement, but they may be dismissed as exceptions to the rule.

Objective Factors.

The degree to which the government agencies endeavor to regulate any type of enterprise affects the decision as to which form to select, and is the objective factor determining choice. Government interferences may take the form of:

1. Need for special permission. 2. Taxes. 3. Reports.
4. Other legal checks.

These factors are of little concern to the individual entrepreneur. No special permission from the government is required in connection with entering business under this form. In fact, the corporation is the only one of the three principal forms in use to-day required to secure such permission, to pay special taxes incident to adopting a specific form of organization, or to render special reports to the government. These requirements will be analyzed in subsequent chapters.

The absence of these requirements reacts favorably in the case of the single entrepreneur, since it makes for secrecy not possible in the corporation form, and for freedom from special business taxation.

On the other hand, this form of organization is deprived of perpetuity and limited liability, with their resulting advantages. This fact restricts its use to small scale enterprise, and makes it available only to those whose desire is to avoid government restriction.

Problems.

1. What "government policy" is referred to in line 5 of the first paragraph of this chapter?
2. What happened to infant industries in the United States after the Revolution?
3. What industries are first developed in a new country?
4. What proportion of clothing did Hamilton find was made in the household in 1791?
5. What did Gallatin find in his report of 1810 as to the reasons for tardy development in industry? Explain each of the five reasons.
6. What two events took place between 1810 and 1817 to stimulate production in the United States?
7. Explain the dearth of data as to the growth of manufactures after 1810.
8. What are the three sources of information concerning the nature of industry after 1810?
9. Describe the importance of each factor referred to in question 8.
10. In what fields were the early patents taken out?

11. What was the effect of the Civil War on industry?
12. Explain why industry did not develop rapidly in the years immediately following the Civil War.
13. Summarize the development of agriculture, manufacturing, and mining in this country.
14. What was the effect of feudalism on world enterprise? What was the effect of the industrial revolution?
15. Describe all the necessary elements entering into a valid contract.
16. Is it possible for married women to make contracts?
17. R. B. Wells is in business netting a profit of \$5,000. Under what circumstances would he be benefited by taking on a partner? Why might he hesitate in doing so?
18. What government interference would be exercised in controlling Mr. Wells' business if he is operating a restaurant? A cigar store? Would these same restrictions operate against a partnership or corporation engaging in the same fields of business?
19. Are there any government restrictions *peculiar to* the individual entrepreneur as such?

CHAPTER III

PARTNERSHIP ORGANIZATION

The partnership form of enterprise may be defined as an association of two or more individuals, each contributing his particular quality, whether wealth, skill, intelligence, or other attribute, for the purpose of carrying on business at a profit. The very nature of this form of enterprise makes it necessary to consider, first of all, its legal aspects. It will be seen here that, contrasted with the individual entrepreneurship, the partnership is both a business *organization* and business *enterprise*, involving as it does, a relationship existing among individuals. This group idea also suggests the fact that partnerships are contractual in nature, and it may be added that this contract may be:

1. Written.
2. Oral.
3. Implied.

The Written Partnership Contract.

The safest and wisest policy is, obviously, to establish the partnership relation by means of a written agreement. It will be pointed out later in this chapter that contention among partners is likely to arise even among the most intimate and friendly parties. In the partnership each partner receives one vote in matters of control, even though the amounts of money contributed by each to capital differ, while in a corporation each stockholder receives a vote for each share of stock he holds. Thus the partner with but little money invested has as much "say" or "boss-control" as the other partners, while in a corporation a stockholder with little money invested has little or no share of control. Obviously, it is essential that the welfare of the enterprise requires the reduc-

tion of potential confusion and the written contract may go far in fulfilling this requirement. This written agreement varies among partnerships, but the following one contains typical provisions.

Articles of Partnership.

Agreement made at Syracuse, New York, this day of 1927, by and between A. L. Witman, C. S. Meyer, and P. B. Thompson of said city, witnesseth:

1. Said parties agree to become and continue as partners in the Electrical Manufacturing business at Syracuse, New York (and, or, at such places as may hereafter be mutually agreed upon) from the first day of August, 1927, to the first day of August, 1947, and from year to year (or for similar periods) thereafter and until one or more notify the rest to the contrary in writing during such first or any subsequent period.

2. The firm name and style shall be WITMAN, MEYER, AND THOMPSON, and the same shall not be changed except by mutual consent and shall be used for all firm purposes but not otherwise.

3. The capital of said firm shall be \$106,000 to be contributed by said partners as follows: A. L. Witman, \$40,000; by C. S. Meyer, \$33,000; by P. B. Thompson \$33,000; all to be paid in cash on or before the agreed date for beginning business, except that said A. L. Witman may assign to said firm real property and machinery, and the same shall be accepted as \$25,000 of his contribution. There shall be no increase or decrease in said capital except by mutual consent, and as mutually agreed upon.

4. Said A. L. Witman shall be entitled to receive interest at 6 per cent per annum upon the difference between his contribution and the next lower contribution, and the excess profits above such interest shall be divided equally.

5. All moneys received on account of said firm shall be deposited in the firm's name in the bank selected by said firm, and no expenditure above \$. shall be paid except by check signed by the said firm by said A. L. Witman; moneys for employees' weekly payrolls and for minor current expenses may be drawn in lump sums as needed. Said partners shall each be entitled to draw monthly not to exceed \$. in

anticipation of profits from said business, together with such additional sums as may be mutually agreed upon at the end of each fiscal year, not exceeding in the aggregate, however, ninety per cent of the net profits for such year.

6. Said C. S. Meyer and P. B. Thompson shall devote their whole time and attention to said firm business, and said A. L. Witman shall devote as much time as may be necessary properly to attend to all the financial and office affairs of said business. Said C. S. Meyer shall supervise the internal affairs of said business and said P. B. Thompson the outside matters, except those delegated to A. L. Witman. In case of disagreement as to any delegated matter, a majority shall govern. Neither partner shall directly or indirectly engage in any business competing with said firm, nor shall either partner become surety for any other person.

7. Proper account books shall be kept and all partnership correspondence, vouchers, and documents shall be kept at the firm's office. A general account of the firm's assets and liabilities shall be taken on the day of at the end of each fiscal year, to be signed by all partners and permanently kept, each retaining a copy and to be binding on all except for error discovered within calendar months thereafter.

8. Upon dissolution, a general account as aforesaid shall be taken, the firm assets shall be sold and the debts due the firm collected as soon as possible, and the proceeds paid out as follows: (1) in paying debts of the firm due third persons; (2) in paying each partner any amount due him for sums advanced in excess of his agreed share of the capital; (3) in reimbursing each partner proportionately to the actual capital by him contributed; (4) the balance, if any, to be distributed equally after deducting any interest still due A. L. Witman as provided in item 4 above.

9. These articles may be amended from time to time by unanimous consent in writing signed by all the parties hereto. In witness whereof we have hereunto signed our names this day of 1927, at Syracuse, New York. Executed in quadruplicate, each retaining a copy, the fourth to be placed and to remain in the office of the firm.

(signed) A. L. WITMAN

C. S. MEYER

P. B. THOMPSON

An examination of the articles of co-partnership would bring to light certain requirements which need to be met to make the partnership legal. Further, by closely following such a document, it will be seen that points are suggested which might be entirely overlooked. The contract usually contains the following points:

1. The names of the parties to the agreement, date of contract, name of the firm, purpose of the enterprise.
2. The duration of the partnership.
3. Amount of capital of partnership, amount each partner contributes, when it shall be in possession of the firm, what kind of capital is given by each partner.
4. Manner in which each partner shall share in profits and losses of the business, what part he shall take in the active management of the business (if any), and the like.
5. Provision for the division of assets in cases of termination.
6. Provisions for the continuance of the partnership in case of withdrawal, death, or other incompetency of a partner.
7. Description of the manner of accounting and book-keeping to be used.
8. Signature of the parties to the agreement.

Oral and Implied Contracts.

The partnership relation may be established, as previously indicated, not only by the written contract just analyzed but also by oral and implied understandings. At best, the contract is certain to give rise to misunderstandings among partners, but this possibility of misunderstanding is reduced in some measure wherever contracts are in writing. Where misunderstandings arise out of oral agreements, it frequently becomes necessary to determine the intent of the parties through court action.

In case of implied contracts, one's conduct may lead others to believe that he is a partner with another person. Should innocent outsiders, such as creditors, sustain loss through acting upon such a belief, the person

guilty of the misleading conduct will be held liable just as though the partnership actually existed. No defense to the effect that written or oral partnership contracts had never been entered into will avail.

For example, in one instance X and Y, brothers, inherited their father's enterprise. Together, they ran the business at the same old place and in the same way it was carried on by the father. Periodically, they shared equal amounts of money from profits. In a like manner, they invested borrowed money in the business. Upon failure to repay certain debts, they were sued as partners. The court held that their relationship was that of partners rather than managers of their late father's individual enterprise. No contract, written or oral, had existed at any time.

The Partnership Not a Legal Entity.

We have seen that the contractual relationship is a significant characteristic of the partnership form of enterprise; that is to say that the partnership can exist only where there is a written or an oral or implied contract. Probably the next most significant characteristic of this form arises out of the fact that it is not a legal entity. By this statement is meant that the partnership as an organization distinct and isolated from its members is, in general practice, not considered to be existent. A single illustration will serve to make the point clear. Let it be supposed that the partnership established under the contract reproduced on pages 31 and 32 has purchased goods to be used in conducting the enterprise and that such goods have been secured on credit. Upon failure of the partnership to pay its debt, suit cannot be brought against the partnership as an organization, but rather against the partners either jointly or severally. Had the partnership been an entity in itself, the suit would have been brought against it, and in case it did not have sufficient funds out of which to pay the debt, recourse could not have been had to the private fortunes of the partners. We shall find in a future chapter that the corporation differs from the partnership in this re-

spect, in as much as it is created not by contract among the members, but rather by a contract between the state and the corporation as such, the state creating the entity recognizing it as a thing apart from the members of the organization. Thus, suit for debt owed by a corporation is brought against the corporation rather than against the members of the corporation, usually termed stockholders, and in case the corporate funds are insufficient to satisfy the debt, the creditors are compelled to suffer loss, since they have no recourse to the private fortunes of such members.

Subjective Factors Affecting the Use of the Partnership Form.

In the matter of the subjective factors of risk, profits, control, and perpetuity, which operate to determine the choice of the type of enterprise through which to carry on productive operations, the following outline is suggestive:

1. The degree of control.
 - a.* Divided control.
 - b.* Danger of disagreement.
 - c.* Lack of flexibility.
 - d.* Lack of individual effort.
 - e.* Combined wisdom and judgment.
 - f.* Minority representation.
2. Risk distribution.
3. Dilution of profits.
 - a.* Necessity for division of profits.
 - b.* Limited capital supply.
4. Permanence.

A brief discussion of each of these detailed factors will serve to aid in a clearer conception of the true nature of the partnership, its advantages and disadvantages, and its resulting availability for practical use as a business form. This discussion should be made by comparison with the individual entrepreneurship, with occasional references to similar points in connection with the corpo-

ration, discussion of which will follow in the immediately subsequent chapters. It will likewise be necessary to make reference, in that discussion, to the analysis of the individual and partnership forms, by way of comparison.

The Degree of Control.

Divided control.—It frequently happens that an individual, being desirous of securing greater funds of capital with which to conduct his enterprise, is willing to surrender a portion of the control in order to gain the advantage sought. It is also frequently desirable to retain the entire control over the affairs of the enterprise, in which case it is impossible to embrace the partnership form unless a modified form, such as a limited partnership, is adopted. In the common law partnership here discussed, each partner is entitled to participate in managing the affairs of the business and, by the very nature of the case, is called upon to exert all his ability in the successful conduct of the enterprise. Too much emphasis, therefore, cannot be placed upon the importance of the selection of the personnel making up a partnership. Despite the contractual relationship existing, strictest confidence and trust must remain the essential elements in the smooth and successful operation of the undertaking. Thus, while additional capital, skill, experience, or knowledge may be factors dictating the adoption of the partnership form instead of the individual entrepreneurship, they should not be acquired by too great a sacrifice of the spirit of co-operation and group point of view. It will be discovered later that many of the weaknesses attributed to this form of enterprise may be traced to lack of unity of effort, ideals, or methods, resulting in a clash of personalities where all parties should have acted in strictest harmony. The courts of law frequently recognize this necessity for harmony by refusing to enforce the partnership contract, and grant its dissolution on the grounds that it would be folly to legislate or force a relationship upon parties to the contract which is onerous to any or all of them.

While disagreement among partners should not be anticipated as a certainty, the precaution is sometimes taken to put into the partnership contract some provision regulating the control of the enterprise in case of dissension. Even where the agreement contains no such provision, the law may allow the majority to control where the minority might do irreparable damage to the business, although such majority is compelled to protect the rights of the minority. No such arrangement applies as against third or outside parties, not members of the partnership.

Partners have certain obligations which they owe to the firm. Rather, from a different angle, each partner has a right to assist in the management of the firm, and this right becomes an obligation to the other partners. A partner may contribute capital solely, and forego any management of the business. Likewise, he may contribute only his skill and experience, which is to rank equally with the capital contributions of others, and here his duties to the firm are plain. Partners must do unto each other as they would the others should do unto them. Secret deals or profits are obnoxious. The fact that a partner is binding other partners with himself should make him doubly careful of his deals. In signing documents, checks, and the like, the signature should be that of the firm's name, with the partner's signature or initials below to show that the business was transacted through him. In formal contracts it is well to write the names of the partners, stating they are doing business under the firm name of so and so. Great care should be taken if contracts between the partnership and a partner as an individual are made. Usually, in a large partnership, decisions on ordinary business matters are decided by a majority of the partners, but in important matters concerning vital affairs of the firm, the consent of all partners is usually required. In case of the bad management or dishonesty of a partner, the courts will give redress to the other partners and exclude the questionable partner from the firm. But it is better to reach some agreement in such a case by which said partner will with-

draw from the firm. Partners have a right to inspect the books of the firm without hindrance.

Partners of a firm also have obligations toward third parties, or business men outside the firm, which must be reckoned with. A partner who makes contracts with third parties does so acting as agent for the other partners of the firm. While suit may be brought against a partner for such contracts without proving the existence of a partnership, if the third party wishes to bring suit against the other partners as principals, the said party must prove a partnership really exists between the partner acting as agent and the other partners. All contracts of the firm are contracts of each individual member of it, and his share of assets and profits may be used to settle a debt. A withdrawing partner should give notice to creditors of the firm of this fact, so that he will be held liable only for debts contracted before his withdrawal. Otherwise, he is liable for debts contracted after he has withdrawn, just as he is liable for the settlement of firm debts contracted while he was in the firm, to the extent of his private fortune.

A third party may sue as a creditor of the firm or as a creditor of a partner. Suing the firm gives the third party access only to the firm's assets, whereas suing the partners individually gives him access to the firm's assets first, and then, if they are insufficient, to the private fortunes of the partners. Suits are usually brought jointly and severally, a practice which gives the plaintiff access to one and then the other.

Changes may be made in the partnership contract, but such changes should be in writing. Notice of such changes need not be given creditors, as no changes impairing the rights of creditors will hold.

In general, where no specific provisions are made for the rights and duties of the partners, common law rules will hold. Special provisions which are legal will be considered above common law rulings, however. For this reason, the contract is best in writing so that special clauses, such as one stating that the partners shall share unequally in profits, could easily be proved, and disputes

easily settled by reference to the contract. In this way, bitter arguments between the partners are avoided.

Classification of partners.—Partners may be classified as follows:

General partners, who have unlimited liability in connection with the partnership, but who have full management and control.

Special partners, who have limited liability for the affairs of the partnership. Information must be given creditors stating their legal status, if they are to have this limited liability.

Ostensible partners, that is, those who openly act as though they were members of the partnership, although no positive proof that they are actually partners can be shown, and who therefore will be held liable as such.

Secret or dormant partners are those who have not openly declared connection with the management of the business, sharing only in profits and, when discovered, in the losses.

Danger of disagreement.—The division of control just discussed obviously holds numerous dangers by way of disagreement. The greater the number of partners, the greater this danger becomes, and the greater the necessity for careful selection of personnel. Where disagreement results in dissolution, as it frequently does, the members are likely to suffer money loss even though the old partnership business continues under a new management. Likewise, society may be injured through the reduction of goods or services which might have been produced.

Lack of flexibility.—The partnership relation does not permit of as great flexibility of management as does the individual form. In some respects, however, the partnership has the advantage over the corporation in the matter of flexibility. A large number of matters may be taken care of in the partnership by agreement among the partners which, in the case of the corporation, might require a vote of the stockholders, an amendment to the charter, and the accompanying burdens incident to such procedure. In general, the absence of government inter-

ference makes it easier for major changes to be made in the partnership.

On the other hand, the corporation has the advantage in the matter of flexibility in that the stockholders who correspond to the partners in a partnership retain little managerial control, such control being delegated to a central mechanism so that any stockholder does not have the right of agency for all the others as does any partner in a partnership. The net result, therefore, seems to be that the corporation suffers little in the matter of flexibility by comparison with the partnership.

Lack of individual effort.—Individual effort on the part of the various partners to the agreement may or may not be enhanced because of the partnership relation. It is conceivable that an individual may not feel called upon to exert his best effort in the conduct of the business, the benefits of which accrue in part to his partner or partners, who may not be contributing equally in the matter of time and effort.

On the other hand, the great responsibility resting upon the partners should insure the application of their best energy and skill. The direct relation between effort and reward, the direct personal relationship between partners, neither of which is present as among the stockholders in a corporation, where the reward comes largely from mere capital investment without skill or energy, should result in increased production and greater profits, benefiting both society and the enterprise as such.

Combined wisdom and judgment.—In this respect, the partnership is more advantageous than the individual enterprise. The opportunity for several individuals to combine their ability and experience, each attending to that part of the business for which he is best fitted, and the opportunity for a partnership to be formed where one man contributes capital, another services, and another prestige, are all factors of supremacy over the individual organization.

As compared with the corporation, however, with its power to attract and hold big men of excellent ability in their particular fields, the partnership is deficient.

The element of "bigness" and the advantages of large-scale production and combinations can never become a part of the partnership enterprise on account of the unlimited liability feature attaching to this form. It is essential, therefore, for the partners to supply whatever executive ability is necessary from their own ranks.

Minority representation.—With respect to the minority partner's representation in the control of a partnership, it is obvious that a man entering business with but little capital finds this form of enterprise superior to the corporate form. In a corporation, the minority stockholders have little or nothing to say concerning the management of the business, beyond the rights given by law and by the charter. The minority partner in a business may hold out for his rights and at least get a compromise, or else be bought out, usually at a figure concerning which he has something to say. One of his most powerful weapons is the threat to dissolve the enterprise by his withdrawal. The fact that each partner is an agent for all the others and may bind them by his actions gives the minority partner a weapon not possessed by the minority stockholders or minority group of stockholders. This advantage of minority partners over minority stockholders will be more clearly perceived after a thorough study of the corporate form of enterprise to be made later.

Risk Distribution.

In addition to the control factors analyzed in the immediately preceding paragraphs, the choice of the form of enterprise to be adopted rests partly upon the distribution of risk among the individual members. In this respect the corporation excels. It has been shown elsewhere that the partnership is not a legal entity and cannot be thought of in any terms except those of the members comprising it. Therefore it cannot, as such, pay its own debts, but the creditors are forced to look to the individual partners for satisfaction of their claims against the partnership. Thus, if you, a millionaire, invest one lone dollar in a partnership, you immediately become ex-

posed to the danger of losing your entire million, should the partnership accumulate debts to this amount, even though your own investment is only one dollar. When it is considered that any one of the partners may enter into contracts or assume debts on the part of the partnership which will bind any or all of the remaining partners, the danger becomes much more emphatic. The greater the number of partners, the greater the risk.

Obviously, where size is essential to economic production of goods or services, the partnership is not practicable. It may be suggested here, that the corporation, with its limited liability to stockholders, forms the most satisfactory vehicle through which the need for size may be satisfied. The truth of this observation will be more clearly recognized after a detailed study of the corporate form.

Dilution of Profits.

Assuming that the profits of an enterprise are fixed in amount, any additional members taken into a partnership require that each partner receive a lesser portion of the total profits than formerly. Under these circumstances, it would be unwise to change from an individual enterprise to the partnership, if the entrepreneur is vitally interested in the making of profits. Presumably, however, additional members, bringing with them larger funds of capital, higher degrees of skill, experience, and intelligence, will benefit the enterprise to the extent of increasing the total business profits so that each will share an amount at least equal to that originally earned by the individual entrepreneur, and, if the partnership has been as successful as anticipated upon its formation, each should receive more than this amount, assuming that all make equal contributions, or that the profits are distributed equally among the members. Thus, with the combined capital and other resources, the business has become relatively, as well as absolutely, more profitable.

Due to the unlimited liability feature of the partnership, however, the limit to continued combination of re-

sources is soon reached. Here, again, is an obstacle to the wide employment of this form of enterprise, which may be avoided by embracing the corporate form.

While partnerships have this burden of unlimited liability to bear, and consequently cannot raise capital in adequate amounts to acquire "bigness," it is possible that they excel in the matter of securing credit. The *burden* of liability may thus be an *advantage*, in one respect, at least, in that greater relative credit is frequently extended than to corporations, since reliability can be determined according to the reputation and solvency of the individual partners. The corporation, however, through sheer size and permanence is usually able to float adequate loans.

Permanence of Partnerships.

When a partner can no longer take part in the business on account of death, insanity, or withdrawal, the partnership must automatically come to an end, since the parties to the contract are not now all available. The business may continue but under a new contract, and thus, legally, as a new partnership. This inability of partners to transfer their shares, either by sale, will, or inheritance, increases the unavailability of the partnership form for wide use, and causes its permanence to be highly speculative. The larger the number of partners, the greater the probability of early dissolution. Business cannot reach great proportions in this way, for if thirty men are associated as partners and one of them becomes legally unable to continue as a partner, the partnership is dissolved for all the rest. The corporation, with its feature of transferability of shares, is more acceptable where permanence is to be desired.

A partnership may be terminated voluntarily or involuntarily. The partners may mutually agree to wind up the firm's business, which may be done according to the written articles of co-partnership, or according to common law rulings. In such cases, dissolution is usually accomplished with little friction and to the satisfaction of all partners.

However, a partnership may be dissolved by operation of law in such ways as the following:

1. Death, or withdrawal of a partner. By special provisions in the partnership contract, the death or withdrawal of a partner need not effect a liquidation and general discontinuance of the business, but if no such provisions are existing, the liquidation of assets may be insisted upon, and the partnership may lose its commercial identity. In any case, the contract of partnership would have to be drawn anew, a new partnership legally would be created, and the original partnership would be dissolved.

2. Bankruptcy of a partner in the firm. This would naturally interrupt the business transactions of the bankrupt and be as effective as if he had become incompetent, or died.

3. Where the firm object has become unlawful. As an example, the prohibition amendment would, naturally, make the liquor business unlawful.

4. Alteration of the firm. If new partners are added, or partners withdraw, such action would terminate the firm, as previously discussed. Additions of capital and the like would have the same effect.

5. War. Where a partner may be a citizen of the enemy country, his contracts would naturally be ineffective, and the partnership would not be recognized.

A third way, generally, for the termination of the partnership is by judicial decree for various causes. Partners might seek to dissolve the partnership by having a partner excluded because of incompetency or fraudulent conduct.

From these three general methods of termination, it will be seen that a partnership can be so easily dissolved that its duration is uncertain, to say the least.

Procedure in dissolution.—In the event of the partnership being terminated, there is a certain procedure for winding up affairs so that obligations are met to the satisfaction of the law. Obligations must be met in the following order:

1. Creditors, other than partners. 2. Partners, other than for capital or profits. 3. Partners, with respect to capital. 4. Partners, with respect to profits.

In the event of the death of one partner, the remaining partner or partners have the sole right of winding up the firm's business. This includes paying firm creditors, collecting debts, disposing of firm property, and the like. Notification of those with whom the firm deals is necessary, so that no further obligation of this particular partnership may be incurred. The surviving partner or partners act as trustees, and the legal representatives of the decedent have no legal right to attempt to run the business or wind up its affairs. In case of the death of the last survivor of the partnership, his legal representative shall take charge and the same right of disposal, as stated in the above case, shall be his. The survivor or his representatives must wind up the affairs quickly and must act in utmost good faith, and with due care. The survivor must make a legal accounting as to how money was obtained and disposed of, and he may bring suits for the partnership. In case of his failure to act properly, a receiver may be appointed to do his work. A receiver is also appointed when the surviving partner happens to be an infant, an alien, or an insane person, and so forth, and the laws regarding receivership apply in both these cases.

Objective Factors Affecting the Partnership as a Type of Enterprise.

One of the chief advantages of the partnership form of enterprise is its facility of formation. The ease of forming a partnership is readily appreciated. Two or more individuals may decide to unite and engage in some business, the preparations for launching a partnership being negligible. The partners may, and usually do, draw up a contract in writing, called the articles of co-partnership. This step requires almost no time or effort when compared with the duties of the promoters of a corporation.

Not being recognized by the state, the partnership form is freed from regulation by the state, from both the stand-

point of securing a charter or franchise from the state and that of paying to the state, organization fees, franchise taxes, income taxes, and other onerous taxes levied against corporations. It is not necessary that the partnership contract be filed with the county clerk or some official of similar capacity, except in the case of a limited partnership, but other than this the partnership is allowed to proceed very nearly as it pleases, so long as it is within the law.

Limitations Upon the Use of the Partnership.

When Mr. Carnegie, testifying in 1912 before the Congressional Committee which was investigating the United States Steel Combination made the statement that he would prefer a partnership form consisting of thirty-five young men, each of whom would be vitally interested in the progress of the business, over any corporation that might be formed, he was doubtless assuming a theoretical case in which such a group possessed all of the qualities he would demand in men, and in which all could live indefinitely, all friction being reduced to zero and no individual losses being sustained because of the unlimited liability of the partnership. For it has been shown that, in actual practice, dissolution is certain over short periods and unlimited liability condemns the partnership to use only in small enterprises. While Mr. Carnegie resisted the need of incorporation longer than most other steel producers, he was eventually compelled to surrender in favor of the corporate form. In fact, he profited to a large extent by his corporate manipulation in the steel business.

Only the smaller mercantile, professional, and manufacturing enterprises can make use of the partnership form of enterprise at the present time. Law partnerships are not uncommon. In fact, a great many professions have been denied the right to incorporate. An illustration of this is the medical profession. This denial has been based upon the theory that professional services could not be rendered by a fictitious or artificial person. A doctor, for example, must be a human person, and on this

basis a corporation must be barred from rendering professional services.

The partnership has also been maintained to some extent in the needle trades, in some small retailing concerns and in brokerage firms, although these, where not incorporated, are largely dominated by the individual proprietorship. The Baldwin Locomotive Works, now a corporation, is probably the outstanding example of successful large partnerships in the manufacturing field.

Partnership insurance.—Some weaknesses of the partnership form may be avoided by the use of life insurance taken out and paid for by the firm, which is the beneficiary, the members, either singly or jointly, being the insured. There are several advantages in this procedure.

In the first place, the embarrassment incident to the death of a partner tends to be reduced; for the proceeds of the policy should make it possible for the surviving members of the firm to dispose of the interest of the deceased without disturbing the remaining interests through a liquidation procedure.

Secondly, it frequently becomes desirable to maintain business policies which have been established, and in order to do so it may be necessary to buy the interest of the deceased from the heirs, so as to keep out disturbing elements in management. The heirs might be unfitted to succeed to their proportionate control, through ignorance or indifference. The proceeds from the insurance policy enable the survivors to make the necessary purchase.

A third advantage in partnership insurance is found in a higher degree of credit. The dissolution of a firm by the death of a member, with the resulting withdrawal of capital, tends to weaken the position of a firm in the matter of credit. Individuals or banks are usually more willing to extend credit, however, where partnership insurance has been established to maintain the organization as a healthy, going concern, even in the event of the death of one of the partners.

Finally, if the deceased has been endowed with some particular skill or talent, it is probable that some time

must elapse before a new party may be discovered to take his place. This period is bridged safely when the proceeds from the insurance policy place the firm upon a sound basis.

However, no such device as insurance is sufficient to supply the partnership form with advantages which make it acceptable in any large measure. Therefore the remaining chapters included in Part I deal with the evolution or development of special forms of enterprises, and especially the corporation, which have arisen in the struggle to make the most advantageous adjustment of risk, profits, control, and government regulation.

Special forms of partnership.—Partnerships may be either general or common law partnerships, or limited partnerships. The general partnership is the one which has had consideration in the major portion of this chapter. The limited partnership differs from this type mainly in respect to the obligation of the partners. At least one of the partners to the partnership contract must be a general partner having, to the full extent, responsibility for the firm obligations, the limited partner or partners being limited in individual liability to the amount of his or their investments. The possibility of using this type of partnership is confined to the states which permit and regulate their organizations and operation. Usually the management of the enterprise is reserved for the general partner, since his is the greater risk, and profits are distributed according to the partnership agreement.

Where this form of partnership is permitted, the statutes generally confine its use to mercantile, manufacturing, and mechanical activities, and demand exact compliance with certain formalities indicated in the statutes. It is quite commonly required that a certificate be filed with designated officials, containing, among other things, the following information:

1. The name and nature of the enterprise.
2. The proposed duration of the partnership.
3. The names of the various partners and the amount of capital subscribed by the special partners.

Should a limited partnership organization fail to com-

ply with the statutory requirements, the partners are treated as general partners and as such inherit the unlimited liability feature. The terminations of general and special partnership are brought about in similar ways, the advantage to the limited organization lying in the fact that greater funds of capital may be accumulated where some contributors risk only their investment and not their entire personal fortune as in the case of the general partnership.

A simple limited partnership agreement will serve to emphasize the nature of this form of organization. Suppose, for example, that Witman, Meyer and Thompson had wished to organize under this form instead of as a general partnership. A simple agreement might read as follows:

State of _____ }
County of _____ } SS.

The undersigned, A. L. Witman, C. S. Meyer, and P. B. Thompson hereby form a limited partnership pursuant to the Statutes, and for such purpose certify as follows:

I. The firm name of said limited partnership shall be Witman, Meyer and Thompson.

II. The general nature of the business to be transacted is the manufacture and sale of electrical appliances.

III. The names, both Christian and surname, of all the persons herein and hereto, and the respective places of residence, are as follows:

Albert L. Witman, Syracuse, New York.

Carl S. Meyer, Syracuse, New York.

Philip B. Thompson, Syracuse, New York.

The first two of whom are general partners and the third is a special partner herein.

IV. That the said special partner has contributed to the stock of said partnership, \$33,000 in cash.

V. That said limited partnership shall continue from August 1, 1927, to September 30, 1947, on which latter date the same shall terminate.

In witness whereof we have hereunto set our hands and seals this first day of August, 1927.

ALBERT L. WITMAN
CARL S. MEYER
PHILIP B. THOMPSON

Before this document can be filed and recorded with the county clerk it must be acknowledged before a notary public or other officer competent to take acknowledgments.

Other modified partnership forms.—In point of time, a partnership may be of a temporary nature, as where there is an association of a number of mine owners co-operating in developing a mine. This is known as a mining partnership. It is frequently provided that death of a partner in such an organization does not dissolve the partnership, since continuity of performance is essential in this form of industry.

When it becomes important that the weaknesses of the general partnership as a business unit be obviated, it is probably increasingly customary to incorporate in order to secure all of the advantages accruing to that form of enterprise. Sometimes some of the advantageous features of the partnership may be realized and some of the advantages of the corporation attained by embracing, where statutes permit, intermediate forms such as:

1. Limited partnership associations.
2. Joint stock companies.
3. Massachusetts trusts.

In as much as these forms partake of some of the features of the partnership and some of those of the corporation, it has been deemed wise to postpone their discussion until after a rather detailed consideration of the corporate form. They will therefore be considered in Chapter XVI, Avoidance of Partnership and Corporate Weaknesses.

Problems.

1. A partnership engaged in the retail clothing business at the corner of Salina and Adams Streets was composed of three members, Slater, Abbott, and Johnson. Slater and Abbott desire to move the store three blocks north on Salina Street. Johnson objects. May the location be moved without the consent of all members of the firm?

2. Nelson sued Brandt for services as a salesman. By agreement between the parties, Nelson was to receive 10 per cent of the profits on the sales made by him. Brandt contended

that this agreement made Nelson a partner in the business, and that his only remedy was in a court of equity for a share in the profits of the firm business. Is there an implied partnership here?

3. Boyle brought suit against Bird for a debt owing to him by the firm of Rigney and Bird. Bird proved that when the debt was contracted he had an agreement with Rigney that he, Bird, would be responsible for only one-third of the firm's debts. Can Boyle recover the entire amount of his claim from Bird alone?

4. Witman, Meyer, and Thompson desire to engage in the manufacture of electrical appliances, each contributing \$33,000 to the enterprise. They propose to start on a relatively small scale and to expand the business in the near future. It is estimated that it will require at the outset at least \$200,000 for plant equipment, and so forth. Argue that they should not choose the partnership form. Is there anything to be said on the opposite side of the question?

5. Why could not the Standard Oil Company and the International Harvester Company enter into a partnership?

6. In problem one, suppose Slater and Abbott are killed in an automobile accident. Who would settle up the partnership affairs?

7. Smith and Jones are partners in the manufacturing of mattresses and bedding. Smith orders an airplane for firm use. If the partnership is unable to make payment, can Jones be forced personally to pay the bill if Smith is without money? Explain.

8. If you were choosing a business partner, what qualities would you demand in him? Why?

9. What would be your status as the *limited* partner in a limited partnership? As the *general* partner?

10. Compare the efficiency of the single entrepreneur with that of the partnership as to the factors of risk, profits, and control.

CHAPTER IV

THE CORPORATION

The development of the corporation.—The increasing extent to which the corporation is being used may be attributed to the need for centralization of larger and larger funds of capital in order to take advantage of what seems to be the greater efficiency of large-scale production. Obviously, there would be few people willing to invest their surpluses, however small, when, as under the partnership form, their entire resources over and above their investment are placed in jeopardy upon failure of the enterprise to maintain its status as a going concern. Prior to the seventeenth century, the corporation idea prevailed in religious organizations, municipalities, labor and merchant guilds, educational institutions, and charitable enterprises. During the seventeenth century, trading companies such as the East India Company, the Royal African Company, and a large number of corporations in the fields of finance, such as banking and insurance, were formed. They also flourished in transportation and public utilities, such as canals and water works, and in the latter half of the century in industrial enterprise. The formation of modern corporation law during the nineteenth century together with rather favorable judicial decisions, established the corporate form as available for practical adoption as a business form.

What is a corporation?—A great deal of difficulty has been encountered in attempting to define a corporation briefly and adequately. For that reason, it is deemed necessary in this discussion to arrive at a satisfactory concept of the true nature of this form of organization after a more or less exhaustive examination of its various

phases. For practical purposes, however, the corporation may be thought of as a device for securing a greater concentration of capital, through the elimination of risk, to those who contribute their savings for the production of goods or services, in return for proportionate shares in the profits incident to such production. But this definition means little until after a closer examination of the factors which enter into risk elimination and consequent greater safety. The most fundamental of these factors is legal entity. This, in turn, gives rise to the following advantages:

1. Limited liability.
2. Permanent existence.
3. Transferability of shares.

It seems advisable to make a brief analysis of the idea of legal entity and the advantages which result.

The legal entity concept.—The meaning of legal entity cannot be adequately demonstrated without returning for a moment to the nature of the partnership organization. It will be remembered that, in the eyes of the law, there is no such concept as a partnership as an entity separate from its members, and that consequently the partnership dissolves upon the withdrawal of a member.

~~Likewise, the~~ creditors cannot sue a partnership as such, nor can a partnership sue in its own name, for, in the eyes of the law, the *partnership* concept does not exist. Therefore the creditors are forced to bring suit against the members, individually or in groups, and the members must bring suit in like manner.

Unlike the partnership, the corporation exists as an entity, without any reference to its membership, and can therefore sue and be sued as an entity distinct from its members. It is commonly said that the state recognizes a corporate organization as having most of the attributes of a *new person*, fictitious in character, but, for legal purposes, as real as a human being. It is obvious that the true conception of such a creation is difficult for the human mind to grasp. This conception may be enhanced, possibly, by a further analysis of the resultant advantages accruing to the corporate form, as a legal entity.

Limited liability.—The corporation, as a person, is liable for its own debts, which it must pay, and for which it may be sued without reference to its members. Thus, if we should invest our surplus earnings, say \$1,000, becoming part owner of a corporate enterprise, and suit is brought by a creditor of the corporation, he may recover from the organization whatever amount the court finds it should pay, but he has no further claim in our personal resources, even though we are members of the corporation. It may be restated that, if we are members of a partnership, no limit is placed on the amount of our private resources which might be recovered by a creditor.

Permanent existence.—It will be remembered that stability and permanence are impossible in connection with the partnership, which may be terminated by bankruptcy, or by the death or withdrawal of any partner. The corporation, being a creature of the state, may be endowed with any length of life which the state sees fit to grant. Where the charter grants perpetual existence, the corporation exists until such time as the stockholders agree upon voluntary dissolution, or until judicial proceedings such as those in case of bankruptcy bring dissolution, or until the state forfeits the charter to the corporation for cause. These possibilities of dissolution will be further considered elsewhere. Where the charter defines the life of a corporation as a period of years, the organization terminates its existence upon the expiration of the period specified, the term of existence usually being renewable for a like period. It will be noted that no condition whatever, existing among the individual members, becomes a cause for termination of the life of a corporation. Obviously, this arrangement makes it possible for a business man to provide for continuing his enterprise even after his death, without subjecting his entire resources to too great a risk.

Transferability of shares.—Permanence of existence is enhanced by the right of individual members to transfer their shares of ownership with entire freedom. Such a right does not exist among the members of a partnership, partners being prohibited from transferring all or

any part of their interest to another party without dissolving the partnership. In corporate organization, however, certificates are given to the members as evidences of their shares of investment, and through a mechanism to be discussed later, these shares may be freely transferred to any other party without interference from other members of the organization.

Attractiveness to small investors.—As a result of the advantages which have just been discussed, a wider field from which to accumulate funds of capital comes into existence. In addition to that which is available from large investors, large amounts are recruited from numerous small investors, who may now put their surpluses to work without jeopardizing their remaining resources. Under no other circumstances would this source of capital be available, nor would any large accumulation of capital be possible.

It is sometimes argued that the state is too liberal in its grants to the corporation which it has created, but little can be said in support of this objection so long as the states do not become too lax in their requirements, or so long as they keep the proper checks on corporate formation and activity. Further analysis will reveal that the very life and functioning of this type of organization are dependent upon the liberality of the contract between the state and the corporation. In fact, it is only these provisions which make the corporation available as an improvement over the partnership.

Mechanism for control.—To avoid the indefinite method of action, as in the partnership, wherein any partner, by his own action, can bind the other partners, it is necessary to devise some scheme by which the interests of numerous members of a corporation may be represented and protected. The mechanism by which this end is accomplished has no equivalent in the partnership, vesting, as it does, the entire administration of the corporate undertaking in small groups of directors elected by members of the corporation, the stockholders, voting according to the number of shares of ownership which they possess. This group of directors in turn elects

officers who execute the policies ordered by the directors, to whom the officers are responsible. In a well-ordered and properly administrated enterprise, it is obviously necessary that the directors and officers be of high caliber from the standpoint of both character and ability.

Disadvantages of the corporate form.—It may be said of the corporate form of enterprise that it reduces risk to the individual investor, that it delegates in a large measure the control of affairs to a board of directors elected by the stockholders, and that the vast majority of holders of shares in ownership are interested only in sharing in profits which are frequently largely due to the advantages inherent in production by means of the concentration of large sums of capital. So far as control is concerned, the election of directors is usually centered in the hands of majority stockholders, made up of a small group of individuals, while the minority and the individual holders have little to say. Where the minority partner may compel some attention to his wishes by the threat to dissolve the partnership by withdrawal, the minority holders of stock in a corporation have no means of accomplishing the same end. The methods of obviating this difficulty will be discussed later.

Government restriction and regulation of corporations militates against the value of the corporation. Charter requirements, burdensome taxes and fees, and public supervision through the submission of reports to the state serve to keep entrepreneurs from embracing this form. These major requirements, coupled with the numerous details incident to organization and management of such an enterprise, render it less acceptable than it would otherwise be. All of these factors will be better understood, however, after a thorough analysis has been made of the type of enterprise in question, and a further treatment will be reserved for the future.

Reference should be made here to certain social evils arising out of the use of the corporate form in America. A future chapter will be devoted to an analysis of these social evils.

Classification of corporations.—Corporations have been variously classified. Since we are concerned with business as a profit-making institution, it seems logical that our classification be made from the standpoint of profit-making and non-profit-making forms. The following outline will emphasize the point:

Profit-making corporations:

1. Private business.
 - a.* Industrial.
 - b.* Commercial.
2. Public utilities (privately owned).
3. Financial.
 - a.* Banks.
 - b.* Trust companies.
 - c.* Savings and loan companies.
 - d.* Insurance companies, etc.

Non-Profit-making corporations:

1. Private.
 - i.* Educational.
 - b.* Religious.
 - c.* Charitable, etc.
2. Public.
 - a.* Municipalities, etc.

This classification is meant to be suggestive only, and for that reason should not be considered as complete. Obviously, each class of corporation is a problem in itself and consequently must be so treated. This discussion must essentially be limited to the first class, private industrial and commercial enterprises, with only occasional reference to some of the other classes. Any treatise on public utilities, finance and banking, social problems, or political science, may be consulted for treatment of the other classes of corporations.

Even with the limitation on the present discussion suggested above, further difficulty arises out of the fact that, while a few of the states may be termed major incorporating states, a thorough mastery of the subject might require the analysis of the practices of a maximum of 48

states which might have powers of incorporating. Discussion must therefore be limited to a more or less general treatment, with emphasis upon the more common practices and the most notable deviations from these practices.

Problems.

1. Secure several legal and accounting definitions of the corporation, and attempt to explain each.
2. Show how limited liability, permanent existence, and transferable shares arise out of "legal entity."
3. Compare the partnership and the corporation, with respect to the qualities mentioned in problem 2.
4. Why would you, as a small investor, prefer to be a member of a corporation rather than of a partnership?
5. Compare the corporation and partnership in the matter of risk, control, dilution of profits, permanence, and government regulation.
6. Secure additional classifications of corporations from texts on political science, law, and so forth.

CHAPTER V

THE WORK OF THE PROMOTER

The people of the world must be fed, clothed, and sheltered. Besides these bare necessities of life, man in his complex and highly civilized city life of an industrial age also regards such things as running water, sanitary plumbing, electric lights, gas stoves, fine furniture, beautiful rugs, pianos, radios, books, automobiles, movies, theatres, magazines, electric household appliances, watches, jewelry, and many other articles, such as a large variety of prepared foods, and all kinds and styles of clothing, as necessities. The business firms which are producing and supplying these articles find that there is no conceivable limit to the human wants and they are creating new ones every day by bringing out new devices which serve a variety of purposes all the way from saving labor to amusement.

A new product gets on the market in one of two ways: by additions to a going concern's established line of products or by the formation (or promotion) of a new enterprise. The securities of these going firms are readily bought on the security market by the investing public. However, the investor will not search out new schemes for making money nor will he pick out new prospective enterprises in which to invest his money. His natural tendency is to invest in some enterprise he knows something about, one that is already proving profitable. Therefore, in order to lure a man with funds into some new enterprise in order that some new opportunity to make money may be properly developed, it is necessary to give him a definite plan or proposition—what the concern in question is going to do, and the means or organization with which to do it. Thus there is the need of a

man who will discover the opportunities to make money, investigate such propositions, assemble and finance them, and thereby produce a going concern. The man who performs these functions is known as a promoter.

Professional and occasional promoters.—When the word “promoter” is mentioned, the average person is likely to think of the fake promoter and the various fraudulent mining and oil promotions by which the public has been too frequently beset. Yet in the past there have been a number of men with a rare combination of those qualities of exceptional ability, energy, and foresight and especially of that undying optimism and enthusiasm, that enabled them to take up the business of promotion as a profession. Charles M. Warner was a shrewd capitalist and promoter who took an active part in the formation of such a variety of types of enterprises as The Cotton Mills Corporation, The Corn Products Company, The American Malting Company, and The Asphalt Company of America. Another man who has made a business of promotion on a large scale is Charles R. Flint. However, today the professional promoter has lost the place of prominence he held twenty years ago, in the formation of huge combinations of small companies which were at that time taking place. His place has been taken by the occasional promoter and the engineering firms which have, within the last few years, gone into the promotion field.

The occasional promoter may be a man of either one of two types, the professional man (lawyer, engineer, and local banker) or a business executive. One can readily imagine how a lawyer, engineer, and local banker are the first ones to whom a person with an invention or an idea to make money would naturally go for advice. Because these professional men are the natural point toward which all ideas for the formation of new enterprise gravitate, and also because of the usefulness of their technical training in the formation of a new company, they have taken up the role of the occasional promoter. Business executives have also become promoters in the consolidation of a number of firms in the line in which they are already engaged.

Engineering firms as promoters.—Now it can readily be seen that the aid of an engineer is necessary in making an investigation to determine the practicability of the project that is being considered, for to form a company to operate a railroad before it is known that the proposed line is possible from an engineering standpoint or to build a plant to manufacture an invention before it is known that it has been perfected, would indeed invite disaster. There are a number of large engineering and construction firms which make it their business to perform the necessary investigations for promoters, for which they charge a fee. If the investigation proves the advisability of continuing the project, many of these engineering firms then do the necessary construction work on contract. These firms are often very large concerns having a large capital and an enormous staff of experts in their employ. Bankers come to these engineering firms for advice before financing a promotion.

Because such an engineering firm has chances to buy out occasional promoters who consult it, and since the firm's experience tends to make it a natural discoverer of new propositions, and it must of necessity keep a large staff occupied, it often takes up the role of a regular promoter.

In this case, the engineering firm does its own investigating, uses its capital to assemble the proposition, and then submits the whole scheme to bankers who carry the promotion from that stage on. Of course the engineering firm may be required by the bankers to take an interest (preferred or common stock) in the concern promoted in order to show their confidence in the project. The bankers may also ask the engineering firm to supervise the operation of the new enterprise in its initial stages, paying the firm a fee. Among the most prominent of these large engineering and construction firms which investigate propositions and do the construction work, as well as promote new companies themselves at times, are Stone and Webster Corporation of Boston, J. G. White Company, and the H. L. Doherty Company.

A number of large manufacturing concerns, such as

The General Electric Company, finance new enterprises with the idea of obtaining their orders for electrical equipment. The "G. E." stands out from most of the others, having been very successful in this field through its Electric Bond and Share Company, which disposes of the securities of the enterprises it wishes to develop. It can readily be seen what creative selling this is, for the large concern that has machinery and equipment to sell does not wait until a market has been created for its products, but creates a market for its own goods by promoting new enterprises which have need of them.

The Stages in Promotion.

In our previous discussion and throughout the remainder of this chapter we may, for the sake of clearness, consider for the most part that there is only one promoter. However, this is not always the case, for as a rule two or more promoters or capitalists form a *promoting syndicate* which is organized much like the partnership association (discussed in a subsequent chapter) with a syndicate agreement. One member becomes the syndicate manager. The members agree to pay into a common fund which is to be used for developing the new company. The syndicate first calls for a small percentage of the subscriptions to pay for the promotion expenses which include the preliminary and detailed investigations explained below. The stages in promotion are:

1. Discovery of idea and preliminary investigation.
2. Detailed investigation.
3. Assembling.
4. Financing.

These stages in the work of promoting a new enterprise will be taken up in the following sections in their natural order.

Discovery of idea—first stage in promotion.—By his very nature the person conceiving an idea has a boundless enthusiasm for the creation of his own mind. Likely he is partial to it. An inventor is usually a man of

mechanical skill, cleverness, and originality, but he cannot test the value of his invention by determining its economic value. It is for this reason that an inventor is called "an impractical genius." Besides this he does not have the "business head" nor the "gift for organizing" that the trained promoter possesses. Thus it is best for the discoverer of an idea to turn it over to an impartial investigator, a trained promoter who can weigh the elements of success and failure.

The promoter will then make the preliminary investigation of the idea or invention. In so doing, he makes a rough estimate of whether or not it will pay to make a detailed investigation as discussed in the next section. He estimates the probable revenues and expenditures of such a company as would be needed to market this idea. He compares this estimate with the revenues and expenditures of going firms in similar lines. If the idea is an invention, the promoter consults a patent lawyer as to his opinion on the possibility of patenting it, and, if it is already patented, as to whether the patent is broad enough to ward off all future claims. And, as a result of this preliminary investigation which the promoter makes, he determines whether he wants to buy the idea or invention from the originator. In some cases the inventor is taken into the promotion syndicate, which is formed to promote the idea, and is given stock in the syndicate which entitles him to stock in the company which is being promoted.

Detailed investigation—the second stage in promotion.

—The general purpose of a detailed investigation is to discover hidden weaknesses in the plan, to determine the amount of funds needed, and to estimate the operating expenses and probable income of the proposed company. When the work of the investigation is completed, the findings are put up in a neat typewritten report of some hundred pages or more, giving the data collected, estimates on costs and income, and opinions of authorities in particular fields, such as engineering. However, it often happens that such thoroughness in investigation is lacking, especially in readjustments and combinations of go-

ing concerns. It may happen that a casual incident, a little thought, and a superficial inquiry are the sole bases of action for the investment of huge sums of capital. A good illustration of this is the purchase of the Bethlehem Steel Company by the U. S. Shipbuilding Company in 1902. Mr. Dresser (President of the Trust Company of the Republic) and Lewis Nixon were lunching together on June 11, when Charles M. Schwab came up to them and said, "Why don't you buy the Bethlehem plant?" Within three weeks it had been arranged with Mr. Schwab (President of the United States Steel Corporation) that the Bethlehem plant be turned over to The Shipbuilding Company for \$10,000,000 collateral trust bonds, \$10,000,000 preferred stock, and \$10,000,000 common stock, of the Shipbuilding Company.

A detailed investigation, such as is explained in the following sections, includes an exhaustive research into all the problems concerned in the formation of the new company and also those problems that it will have to meet upon coming into being. These include: the production problems, settled by the engineer or chemist; discovery of demand and the proper method to reach it, settled by a market analysis expert; the question of proper patents, settled by an expert patent attorney; the problem of the proper location of the plant, taking into consideration such factors as transportation, nearness to raw materials and to markets, satisfactory labor supply, and a favorable climate; and the question of whether the capitalization is sufficient or the proposed company *over-capitalized*. In short, what is determined by this detailed investigation, is whether the estimated income is large enough to take care of:

1. Operating costs (estimated).
2. Interest on capital invested.
3. Compensation of owners for risks and services.

Amount of capital needed to operate.—What, then, are the factors affecting the amount of capital needed to operate? If the project is in the nature of a public utility or railroad, it will be necessary to invest large amounts

of capital in equipment and property (fixed assets). On the other hand, if an article is to be manufactured, less capital will be needed than in the case of the railroad or public utility. Whether the proposed company is going to start on small- or large-scale production must also be considered. A third factor affecting the capital needed is whether the new enterprise will be a marketing concern only, or manufacturing as well as marketing.

In turn, the method of handling production affects capital needed to operate. There are three main methods as follows:

1. Doing one's own manufacturing with owned machinery, buying or leasing plant.
2. Contracting to have product manufactured, owning patterns and special tools.
3. Assembling own product, making no parts or only a few.

We may now inquire as to when the small-amount or no manufacturing plan should be used and when both manufacturing and marketing should be attempted. If the promoters found it difficult to raise capital, the method requiring the smallest outlay would be selected, which would mean marketing only and contracting for the manufacture of the product. Also, with a high-load factor (large amounts of money invested in machinery used infrequently), a seasonal business, or any risk of failure, the contract method of manufacturing would be adopted. On the other hand, both manufacturing and marketing would be decided upon when the contemplated enterprise is a sure success with a steady demand and with large-scale production possible, and also when secrecy or the quality of the product is important. Having selected the assembling method with contract manufacturing, many firms, after they have been in business for a time, decide to manufacture the entire product in order to lower the production costs to meet keen competition.

Calculating the total capital requirements.—After the promoter has decided on the production plan the proposed company will use, and thus is in a position to estimate the

amount of capital that will be needed in the form of fixed assets, his next problem is to figure the total amount of money (total capital requirements) needed in order to put the project into operation.

In calculating the total capital requirements, there are five main costs to consider. The first of these costs is the promotion expense (considered in detail in a later chapter) which includes the incorporation fee, office expenses, lawyer fees, and the cost of the fixed assets necessary for the business to begin with, such as buildings, machinery, and office equipment.

The cost of establishing the business should not be lost sight of. This cost is estimated by a market analysis expert, and is the amount by which the expenses exceed the income for the first few months, which may be from three to six months. Next there is the amount of cash or liquid capital which is advisable for the business to have on hand; that is, the working capital. This working capital supplies the funds necessary to run the business, and if the company buys and sells on 30 days credit, it will need an amount equal to the operating expenses for one and one-half to two months. There should also be a margin of liquid capital provided to take care of contingencies and to give the company a good credit standing. Lastly, there is the cost of financing. This includes the total cash needed to be raised and the cost of raising this money. The cash needed takes care of the costs mentioned above with an addition of 10 per cent for contingencies which may occur in the course of organizing.

The cost of raising the money ranges from about 2 per cent to 15 per cent or more of the money raised, depending upon the method used. In case the money needed is raised almost entirely from members of the promotion syndicate, there is practically no cost; but this method is seldom used. A second method is the direct selling of the securities of the new company to the public by means of salesmen. In this case, the cost would be 20 per cent or higher, depending on the reputation of the men back of the new enterprise, the nature of the enterprise, whether highly speculative or not, such as an oil adventure or the

manufacture of some article for which there is already a recognized demand, and lastly, the condition of the investment money market. The third method of raising the needed capital is through an investment banking house underwriting or buying outright the securities of the new company, in which case the costs of raising the money will be 2 per cent or more. These methods will be taken up in detail later under the section "Financing."

Many new companies have made a fine showing at the start, but have collapsed when their cash became exhausted. Numerous companies have failed because of inadequate working capital, among them the U. S. Shipbuilding Company formed in 1902 and reorganized in 1904. In general there are three main causes for insufficient capital. The first of these is the great tendency of promoters to underestimate the cash or working capital needed. This may be due either to a neglect to provide sufficient working and fixed capital or to an understanding of such expenses as organization or selling expenses required to start the company and to dispose of its capital stock. The second cause of insufficient capital is a loss in capital in organizing and starting the enterprise due to carelessness in not ascertaining all the available facts before making the investment, or in neglecting to clinch the legal rights of the organizer by means of contracts, options, or the outright purchase of some of the essential property. These causes are just a few of the hundred and one things that may happen to diminish the capital of the new company to such an extent that it is handicapped or even forced into a reorganization. However, there is a third common cause which is perhaps more inexcusable than the other two—the failure to establish close relations with financial houses which would have assisted the company through the construction stage to the period where its securities could be sold as issues of an established concern.

Two methods of calculating total capital needed.—It may be said that there are, in general, two methods of calculating the total capital needed, the estimating method and the comparison method. By the estimating method

an estimate is made of the various costs of investigation, fixed assets, and so forth, as discussed under the section entitled "Calculating the Total Capital Requirements." It is also fairly easy to estimate the sum needed to bind all necessary options on patents and land.

By the comparison method an attempt is made to find a number of concerns similar in size and condition to the proposed company. From the statistics of these concerns, the probable requirements in the way of capital for the new concern can be estimated. Certain cautions must be observed in using this method. It is necessary to select enterprises somewhat similar to what the promoted enterprise is likely to be. It can be seen how an analysis of a single concern may be misleading. It is for this reason that *average* costs and average operating *results* of a large number of concerns are taken and not the costs and results of one firm.

Neither of these methods of calculating the total capital needed is used to the exclusion of the other; each has its advantages. Since the cost of doing business has steadily increased since several years ago, one might find the capital requirements for the new company as suggested by a company promoted before the World War wholly inadequate to-day. The estimation method is, therefore, used first, and the comparison method then serves as a check on the first method as to whether the new company will start in life with adequate capital.

Checking up the investigation.—We have now considered all the factors of the detailed investigation, and a check-up of the work done is the next logical step. There are several reasons why the check-up is necessary. An incompetent investigator may have been hired because the promoter lacked sufficient money to hire the best experts. Or again, the investigator may have been partial toward the proposition investigated, because of a previously acquired interest in the subject, because he knows the promoter wants a favorable report, or because he is influenced by the enthusiasm of the promoter. Then it must be remembered that capitalists and bankers would not be foolish enough to loan the promoters the required

money to bring the new corporation into being before they had their own experts check the investigation report as to accuracy and the advisability of financing such an adventure.

Here again there are two methods used in the check-up—each a check on the other. There is the examination of the report itself for such things as errors, omissions, and false reasoning. A further check is made by the comparison method, whereby the investigation report submitted is compared with the known results of similar going concerns. In doing this, a unit basis of comparison is used. When estimating capital costs, they are figured in units of capacity such as the kilowatt capacity of an electric light plant or by mile-of-track in the case of a railroad. In estimating the revenues, they are often figured on a per capita or customer basis of possible customers. In estimating the cost of operating, it is figured as the cost per unit of product produced.

Assembling—the third stage in promotion.—After a thorough investigation of the proposition in mind has been made, the promoter decides whether he wants to take the risk of the promotion and, together with his banker, he decides on a plan of capitalization which is satisfactory to both. Then the promoter starts to assemble the proposition. By “assembling” we mean protecting the fundamental idea, securing all the property needed by the enterprise, and making contracts with all the men that are selected to fill the chief managerial positions. Under “protecting the fundamental idea” is included not only the securing of patents on inventions, but other methods of safeguarding the idea against exploitation by others through securing options on the key property or obtaining the necessary contracts. As an example of what happens when a promoter fails to protect himself properly, the classical case of Haskins vs. Ryan is often cited. Here a man named Haskins insisted that he had originated the plan whereby the independent lead companies, that is, those not already members of the National Lead Companies Organization, might be united into a new combination. He sought the financial support of Thomas F.

Ryan in his attempt to put his plan into operation. The cause of action centered about Haskins' claim that Ryan froze him out of the proposition after finding out exactly what he proposed to do. It developed, however, that Haskins had secured options running for only a short time and that after they had matured, Ryan stepped in and renewed them for himself. Haskins should have secured options running for a longer time, or else should have protected himself by contract with Ryan. His downfall lay in his failure to secure and maintain personal control of all the elements comprising his organization scheme.

The importance of securing the proper managerial ability cannot be over-emphasized, for good managers, a successful company, and large promoter's profits go hand in hand. However, it is not necessary to go into this personal element further, as the main purpose of this chapter is to explain the technical features of promoting.

Financing assembly.—When it comes to assembling the property, the members of the syndicate are called upon for the remaining portion of their subscriptions in order to thus put the proposition in final shape for financing. The securing of control of the necessary property may be done either by buying options on the property or by buying it outright. The buying-outright method is seldom used, for, in the first place, few promoters have sufficient capital to buy all the property needed. In the second place, they would be investing an unnecessary amount of their own money in a proposition which the bankers may refuse to finance, to say nothing of the possibility of failure of the company after it is promoted. It is for these reasons that the promoters in nearly all cases buy options on the property, the newly formed company taking up these options. An option, by way of explanation, is a contract which the owner of property (real and personal, including rights), for a certain sum of money, gives to a prospective purchaser for the right to buy the property within a certain time at a stipulated price, the price paid for the option being part of the purchase price. Bankers will not advance money to develop a scheme until a definite proposition is presented to them, with options on all

necessary property. Thus the promoter can fulfill the banker's requirements by buying options on property and so subject himself to less financial risk than by buying outright.

Valuation of properties.—The valuation of the properties is especially important in the case of consolidation of a number of similar going concerns. The difference between the combined valuation and the separate valuation represents or measures the value of the promoter's service. In general, there are three ways of determining the value of property:

1. A definite method may be agreed upon, such as taking the sales of the surrounding property or by capitalizing the income from the property.

2. A second method is to employ experienced appraisers, all parties concerned agreeing to abide by their verdict.

3. The last method, that of negotiation, is most frequently used in the final decision on the value allowed for the properties, one of the other ways having been used during the investigation in estimating the property values.

Taking title to property.—After the value of the property has been determined and options have been secured, it is necessary to determine in whose name the title will be taken. Of course the promoter may take title in his own name. Or the property may be taken in the name of a small corporation to be expanded later, as in the case of the United States Steel Corporation. In this instance, a small company was incorporated with a total capitalization of but \$3,000. As soon as the organization of the company was completed, the three original incorporators retired, the real parties in interest came in, and the capitalization was increased to \$1,100,000,000. Then there is the trustee or escrow method as a third possibility. By this method, title to the property is placed in the hands of a trustee to be turned over by him to a corporation upon the performance of certain conditions, such as the payment of certain sums of money for the use of the company that is being promoted.

A good assembling rule for the promoter to remember is that he must keep himself in a position where he is master of the situation. If he does not, he cannot expect any large compensation. He should never fail to secure an option on all property, because this step is the controlling factor in the proposition. Henry Frick lost a clean million when he failed to secure the necessary funds to take up an option on Carnegie's plants a year before the formation of the United States Steel Corporation.

The proposition.—Thus an idea has been conceived, investigated, and checked, and when the necessary assembling has been completed, the promoter has what is known as a "proposition." This proposition is presented to the banker in the form of a well-organized report known as "the prospectus" in order to persuade him that the proposition is worthy of his financing. The prospectus contains a detailed discussion of the whole proposition and is supported by copies of engineer's reports, lawyer's opinions, legal documents, pamphlets, and other material relied upon to show the value of the plan to the prospective financiers of this proposition.

Financing—the fourth stage in promotion.—Perhaps the first suggestion that should be made under financing is the desirability of early connections with the right bankers. That is, the promoters should establish connections immediately with bankers already familiar with the line of business in which the promoter is working.

Steps in financing.—There are three steps in financing a promotion:

The first is the preliminary financing which we have already discussed under the section "Assembling." This is the purchasing of the property upon which options were taken by the promotion syndicate. The money to purchase such options is obtained by calling in a portion of the subscriptions of the syndicate members as explained above.

The second step in the financing is the capitalization of the opportunity. This step, in turn, is composed of two parts, the first being the formation or organization of the corporation to take over the property, and the sec-

ond part being the actual taking over of the property.

This corporation is capitalized at a certain figure, capitalization being the total number of shares of stock issued and any bond issues that the corporation deems it necessary to include. By way of explanation, the ownership of property interest in the corporation which entitles one to dividends is called the stock of the corporation and is divided, for the convenience of ownership, into shares. The usual value of each of these shares of stock is \$100 par value, although it may be of the "no par value" type. Bonds, on the other hand, are formal promissory notes of the corporation, or promises to repay the lender (holder of the bond) at a certain future date, the money loaned it. These stocks and bonds are first issued by the corporation. It then gives a portion of them to the promoters, on receiving from them the property that the corporation itself was formed to take over. At this point it is necessary to secure temporary financing in order that the corporation may make the necessary development and start as a going concern, unless the remainder of the capital stock has already been sold before incorporation under the subscription plan which will be discussed in the next paragraph. The customary plan of temporary financing is to place a mortgage on the property recently acquired by the new corporation, the corporation then issuing bonds not to exceed the mortgage. The bonds are not salable, of course, until the property is actually developed. The corporation deposits these bonds with a bank as security for short-term loans to finance construction, and thus starts as a going concern.

The third step in the financing of a new corporation is the point at which it becomes necessary to arrange for its permanent financing or the sale of its securities. In case the stock had been sold by the subscription plan previous to incorporation, this step of financing would simply consist of calling on the subscribers to pay up their subscriptions in full. Subscriptions are simply agreements whereby the subscriber agrees to subscribe for a certain number of shares of the capital stock of the corporation being promoted, these shares to be paid for at some future

time, either in a lump sum or in installments. There are certain legal questions which come up in connection with subscriptions. In case the corporation is not yet incorporated or organized, the subscription agreement cannot be made with the corporation, for the contract would not be enforceable as it is not legally considered as a continuing offer with the right of the maker to revoke it at will, because there is only one party to the contract, the corporation having not yet come into being. To avoid this possibility of revocation, the subscription agreement should be made with a trustee for the corporation. It is also usual to put into the contract a clause stating that the consideration for the subscription is the subscriptions of other subscribers. The promoter should be familiar with the special rules concerning subscriptions which prevail in certain states, New York, for example, where a subscription, to be binding, must be accompanied by 10 per cent of the consideration. This subscription method of permanent financing before incorporation is not used a great deal to-day, except when it is decided to keep the company a close corporation, meaning that the stock of the company is to be held only by the promoters and those few of their friends whom they permit to come into the company.

To come back to the original assumption that the subscription method of selling the stock of the corporation previous to incorporation is not used in the case at hand, it may be said that, so far, the money which has been put into the enterprise was advanced temporarily by the members of the promotion syndicate. Both the members of the syndicate and the bank which made the short-term loans for the construction, expect to be repaid when the securities are sold after the concern has established itself by making a fair showing of earnings. If the enterprise has been wisely planned and economically developed, the sale of the securities will restore the syndicate's original investment, and either leaving it in control or enabling them to sell out its holdings at a nice profit.

Marketing securities.—There are two general methods of marketing the securities of this new corporation: di-

rect to the public by means of salesmen, or through an investment banking house. The direct method is usually used for issues of less than \$1,000,000. The selling of the securities to the public is done either by establishing a selling organization especially to sell only these securities or by putting the sale of the securities into the hands of some advertising agency. In connection with this method of selling the securities to the public, after incorporation, the subscription agreement is used and is being used more and more every day, especially when the securities are sold on the installment plan, a device which is becoming increasingly popular. The cost of these direct methods of selling is from 25 per cent to 40 per cent of the amount of money raised, as contrasted with a cost of from 2 per cent to 25 per cent when an investment banking house is used. From a comparison of cost, it may be seen why the investment banking house is used whenever possible, but since the investment banker will purchase only the best of the securities offered him, those having the least amount of speculative risk connected with them, the securities of a large number of the enterprises promoted reach the public through the direct method.

The public flotations of nearly all the high-class securities are accomplished by the investment banking house. The securities are bought from the issuing corporation by the banker at a price below what they will bring on the market—thus the banker's profit. The investment banker who undertakes the sale usually associates with him, to help complete the sale, a number of other banking houses in an organization known as an underwriting syndicate. The underwriting syndicate guarantees the sale of the securities, which, for the corporation, amounts to the same thing as having its securities bought outright, since the cash is thus provided at once. The syndicate is simply a method of distributing the load or risk of selling the entire issue of securities. The investment banker, however, is used only for the large issues of, say, over \$1,000,000. As mentioned above, the cost may be as low as 2 per cent of the money raised or may be as high as 25 per cent, depending on the size of the issue, the absence of the

speculative element in the securities, and the reputation of the men behind the new enterprise. Besides the advantage of its low cost, the investment banking house method enables the borrower to obtain cash at once and to know the exact selling cost in advance. Of the prominent investment banking houses, J. P. Morgan and Company, which underwrote the securities of the United States Steel Company at its formation, is one of the most noted. Other prominent investment banking houses are Kuhn, Loeb and Company, Harvey Fisk and Sons, Lee Higginson and Company, Kidder, Peabody and Company, and Speyer and Company.

Legal Status of the Promoter and Nature of His Profits.

As a representative or agent of a yet unformed corporation, the promoter cannot legally bind the corporation by his acts until it accepts or ratifies them, either by taking the benefits of the contracts so made or actually accepting them. The case of Cushion Heel Shoe Company vs. Hurtt is a good example of the question of the liability of a corporation for its promoters' contracts. The promoter of the Cushion Heel Shoe Company, Mr. Johnson, promised Mr. Hurtt to compensate him for services rendered prior to incorporation. After the corporation was formed, Hurtt sued the Cushion Heel Shoe Company on the ground that the corporation was the beneficiary of his services. The court held that in the absence of recognition of the claim by the corporation, it could not be held for the services of promoters or others prior to incorporation. It can be seen that the corporation is not liable for the acts of the promoter on the theory that one cannot be an agent of a principal not yet in being. Therefore, the promoter is personally liable for all contracts he makes, unless otherwise stated in the contract. Some of the pre-incorporation contracts that the promoter would be likely to make are options on lands or rights, leases, and the employment of attorneys, engineers, and other specialists.

Secret profits.—The position of the promoter toward the corporation is one of trust, a fact which prohibits him

from obtaining profits at its expense. The case of Yeiser vs. United States Board and Paper Company is an example of secret profits not allowable. Mr. Yeiser and others obtained an option to purchase a paper mill for \$75,000, with the intention of forming a corporation to take it over. Then the promoters sold the option to the corporation for \$100,000, not revealing that it had cost them only \$75,000. The court held that Yeiser and others were liable to the corporation for the secret profit of \$25,000. When the directors of a newly-formed corporation learn that the promoter has made profits out of the transaction with the company during the period of promotion, which he did not disclose in his statement to the company, they may take one of three courses: (1) rescind the contract, return the property, and receive both the stock or cash that the corporation paid for the property; (2) sue the promoter for secret profits; or (3) sue for any other damages. Of course the promoter is entitled to reasonable *open* profits. It is interesting to note here, that as soon as an independent board of directors has been elected, so that the promoter has to deal with them, there is no question as to future profits made by him.

Legal profits.—It has long been a fundamental and accepted principle of finance that the promoter takes his remuneration in the form of stock in the corporation which he has promoted. The amount of stock to which he is entitled varies with conditions under which he works. Probably the amount received seldom falls below 10 per cent of the total amount of stock to be issued. In some cases, such as where the promoter combines his function with that of inventor and banker, he may hold a controlling interest in the enterprise, that is, 51 per cent, until such a time as he has helped to bring the going concern up to a profit-making position. This rule holds true whether the promoter is combining a number of active enterprises or exploits a new invention or idea.

Justification of promoters' profits.—Much has been said against the huge profits made by promoters, but it is a fundamental rule in business that where a large element of risk exists, there must be a corresponding pos-

sibility of high returns to make the proper adjustment between profits and losses. The promoter of an enterprise takes the greater risk, since the bankers must be assured of relative safety before advancing the money for financing the enterprise. The preliminary finances are provided by the promoter, and at his risk affairs are placed in a position of sufficient stability and promise to attract investors. Since his pay is in common, speculative stock, he must be the loser in case the enterprise fails to be worth anything.

The question is different in the case of the fraudulent schemes which are offered to the public almost continuously. The idea in these cases is usually conceived with the direct intent of securing high profits without giving anything in return. The activities of Dr. Cook and Ponzi are interesting examples of fraudulent promotions. Such activities react, too, against the success of the promotions of purely legitimate enterprises, making the honest promoter's task the greater by placing the wary investor on his guard, thus reducing the market for excellent securities.

To be more specific in regard to the great risks of promotion, there is the case of Seymour Scott of Lyons, N. Y. who carried through two successful promotions and lost everything in a third. Then, too, there is the consideration of the chances of a new enterprise failing. Public utilities are least likely to fail, while manufacturing enterprises are most likely to fail. A promoter not only runs the risk of losing his profits at one of the three stages through which the new corporation passes, but he runs the additional risk of losing the money it cost him personally in order to set up the new enterprise as a going concern. These three stages of risk are:

1st Stage.—Promoter fails to carry through the organization to the point of setting the company in operation and so loses his own expenditures of time, money, and energy in investigating and assembling the proposition.

2nd Stage.—The company is never successful, which means the promoter's profit is lost through the common stock of the company being worthless.

3rd Stage.—The failure of the company after the promoter has put it on its feet, through no fault of his, also means the loss of his profit by the common stock becoming worthless.

Thus we see that the risks of promotion are great, and the man who has sufficient capital and is willing to risk it in the perilous waters of promotion certainly deserves a good sized profit if he succeeds. Moreover, the economic function of the promoter, which was suggested at the beginning of this chapter, should not be forgotten. The promoter is the middleman between the man with money to invest in securities and the man with undeveloped property or an investment to sell. Thus we may conclude that the promoter is entitled to his large profits since he performs an indispensable function for the community by discovering, formulating and assembling the business enterprises by whose development the wealth of society is increased.

Problems.

1. You have invented an artificial honeycomb which you wish to produce and market. Describe the procedure necessary to do so.
2. Examine the records of Ponzi and Dr. Cook as promoters.

CHAPTER VI

THE CORPORATE CHARTER: GENERAL CONSIDERATIONS

When the promoters or incorporators have completed their plan of organization in some manner similar to that suggested in the preceding chapter, they are ready to proceed with the creation of the enterprise through which the plan is to be put into operation. This final step consists in establishing the proper contractual relationship between the state and the enterprise, that is, the creation of the legal entity spoken of in Chapter IV. The contract is commonly known as the corporation charter or certificate of incorporation. The procedure in securing the charter, and an analysis of its normal provisions, will be considered in this and subsequent chapters.

The Origin and Development of Corporate Charters.

The corporate charter or certificate of incorporation is a contract with provisions very similar to those in the partnership agreement. Unlike the latter, however, it is a contract between the state creating the corporation and the corporation itself, although it functions also as a contract regulating the relationship among stockholders. This dual nature of the contractual relationship will be better understood as we proceed. A thorough mastery of the nature of the contract is important.

Originally, in the United States, charter grants were obtained by special acts of the state legislature. At the beginning of the 19th century, business organizations began to avail themselves of the advantages of the corporate form in such large numbers that it became necessary for states to adopt general incorporating laws to avoid con-

gestion in legislative sessions and to eliminate some of the evils incident to securing favorable legislative action toward certain groups. The central feature of these laws is the document known as the charter or certificate of incorporation mentioned in the preceding paragraph.

General business corporations are chartered only by the state, the federal government having the right to charter only certain special businesses over which it has sole jurisdiction, such as national banks. It is obviously impossible for any individual to master the corporate practices of all the states in the union. It is, therefore, necessary to consider the problem in a general way using as illustrations states which are neither ultra conservative in practice, as are some of the newer states with fewer commercial or industrial interests, nor extra liberal states such as New Jersey and Delaware. New York represents such a state and will be used as a basis for discussion.

The Nature of the Certificate of Incorporation.

The first step in securing the contractual relationship referred to above, is the drawing up of the charter application for presentation to the proper state official, usually the secretary of state. This application, if accepted, becomes the actual certificate of the new enterprise. Following is a typical example of a charter containing the minimum provisions. Such a large part of the future discussion centers about this document that it is deemed wise to reproduce it in its entirety.

Certificate of Incorporation of The Witman Electric Company, Inc.

PURSUANT TO ARTICLE TWO OF THE STOCK CORPORATION LAW.

We, the undersigned, desiring to form a stock corporation pursuant to the provisions of Article Two of the Stock Corporation Law of the State of New York, Do HEREBY CERTIFY as follows:

FIRST: That the name of the corporation is The Witman Electric Company, Incorporated.

SECOND: That the purposes for which it is to be formed are to do any and all of the things hereinafter set forth to the same extent as natural persons might or could do in any part of the world, namely: To manufacture, buy, sell and generally to deal in and with electrical appliances and all and any products pertaining to them.

To manufacture, purchase, or otherwise acquire, and to sell and deal in all kinds of materials, goods, wares and merchandise which may be required for any of the purposes of the corporation's business or which may seem capable of being profitably used or dealt in in connection with such business.

To purchase, lease or otherwise acquire, and to hold, own, pledge, use, develop, operate, introduce and sell, or otherwise dispose of, inventions, devices, trade-marks, trade names, letters patent in the United States and in foreign countries, secret formulas.

To purchase, or otherwise acquire, real estate and leaseholds, or any interest therein, in addition to such as may be necessary for the purposes herein expressed, and to own, hold or improve, sell and deal in the same.

To borrow money and from time to time to make, accept, endorse, execute and issue bonds, debentures, promissory notes, bills of exchange and other obligations of the corporation which may be borrowed or in payment for property acquired or for any of the other objects or purposes of the corporation or its business, and to secure the payment of any such obligation by mortgage, pledge and indenture, agreement or other instrument of trust, or by other loan upon, assignment of or agreement in regard to all or any part of the property, rights or privileges of the corporation wherever situated, whether now owned or hereafter to be acquired.

To purchase, or otherwise acquire, and pay for in cash, stock, or bonds of the corporation, or otherwise, all or any part of the business, good will, rights, property and assets of all kinds, and assume all or any part of the liabilities of any corporation, association, partnership or person engaged in any business including the purposes or objects mentioned herein or incidental thereto.

The Corporation may have offices, agencies or branches, conduct its business or any part thereof, purchase, lease or otherwise acquire, own, mortgage and convey real estate and personal property, and do all or any of the acts and things herein set forth outside of the State of New York as well as within said state, and in any of the territories, districts, protectorates,

dependencies or insular or other possessions or acquisitions of the United States, and in any and all foreign countries.

To do all and everything necessary, suitable and proper for the accomplishment of any of the purposes of the attainment of any of the objects or the furtherance of any of the powers hereinbefore set forth, either alone or associated with other corporations, firms, or individuals, and to do any other act or acts, thing or things incidental or pertaining to or going out of or connected with the aforesaid business, or powers, or any part or parts thereof, provided the same be not inconsistent with the laws under which this corporation is organized.

THIRD: (a) That the total amount of capital stock which the corporation is authorized to issue is Eight Hundred Thousand Dollars (\$800,000). Of said total authorized capital stock Three Hundred Thousand Dollars (\$300,000) shall be preferred stock, divided into Three Thousand (3,000) shares having a par value of One Hundred Dollars (\$100) per share, and Five Hundred Thousand Dollars (\$500,000) shall be common stock, divided into Five Thousand (5,000) shares having a par value of One Hundred Dollars (\$100) per share.

(b) The holders of the preferred stock shall be entitled to receive out of the net earnings a (cumulative or non-cumulative) dividend at the rate of 6 per centum per annum, and no more, when declared by the Board of Directors, payable (annually, semi-annually or quarterly) before any dividends shall be set apart for or paid in any year on the common stock.

(c) In any year after the preferred stock has received its stipulated dividends, and any arrearages that may be due and unpaid thereon, if the Directors elect to make further distribution of earnings, such distribution shall be made exclusively to the holders of the shares of common stock.

(d) The Corporation, through its Board of Directors, may, from time to time, redeem on any dividend date, the whole or any part of the preferred stock at per centum of the par value thereof (if cumulative, insert: plus dividends accrued or in arrears). If less than the whole amount of outstanding preferred stock shall be so redeemed at any time, the stock to be redeemed shall be selected in such manner as the Board of Directors may determine.

On and after the date fixed for such redemption, unless the Corporation shall not, after proper demand, have paid to the respective holders of the shares so called for redemption the redemption price thereof, the stock so called for redemption shall

cease to be entitled to any dividends, and the respective holders thereof shall have no other right or interest therein or thereon or in the Corporation by reason of the ownership of such shares, except to receive payment therefor at the said redemption price, upon presentation and surrender of their respective certificates therefor.

(e) In case of dissolution, and after payment of all of the debts of the company, the assets shall first be applied to the payment in full for the preferred stock at par, plus an amount equal to arrearages of dividends, and the remainder shall be distributed share and share alike to the holders of the shares of common stock.

(f) Subject to the provisions of the Stock Corporation Law of the State of New York, the voting power shall vest exclusively in the holders of the common stock.

FOURTH: That the office of the corporation shall be located in the city of Syracuse, County of Onondaga, State of New York.

FIFTH: That the duration of the corporation shall be perpetual.

SIXTH: That the number of directors of the corporation shall be three (3), (add if desired) who need not be stockholders.

SEVENTH: That the names and post-office addresses of the directors until the first annual meeting of the stockholders are as follows:

<i>Names</i>	<i>Post-Office Address</i>
A. L. Witman	220 X Street, Syracuse, N. Y.
C. S. Meyer	1127 Y Street, Syracuse, N. Y.
P. B. Thompson	432 Z Street, Syracuse, N. Y.

EIGHTH: That the name and post-office address of each subscriber of this Certificate of Incorporation and the number of shares of stock which he agrees to take are as follows:

<i>Names</i>	<i>Post-Office Address</i>	<i>Number of Shares</i>
A. L. Witman	220 X St., Syracuse, N. Y.	1,400
C. S. Meyer	1127 Y St., Syracuse, N. Y.	1,400
P. B. Thompson	432 Z St., Syracuse, N. Y.	1,400

NINTH: That all of the subscribers of this Certificate of Incorporation are of full age, at least two-thirds of them are citizens of the United States of America, and at least one of them is a resident of the State of New York; and that at least one of

the persons named as a director is a citizen of the United States of America and a resident of the State of New York.

TENTH: That the following provisions are adopted for the regulation of the business and the conduct of the affairs of the corporation:

(a) The Board of Directors from time to time shall determine whether and to what extent and at what times and places, and under what conditions and regulations, the books and accounts of the corporation, or any of them, except the stock book, shall be open to the inspection of stockholders, and no stockholder shall have any right to inspect any book or document of the corporation, except as conferred by statute in New York or authorized by the Board of Directors.

(b) Any officer elected or appointed by the Board of Directors, or any member of the Executive Committee, or other standing committee, may be removed at any time, with or without cause, by a majority vote of the Directors at a meeting of the Board called for that purpose.

(c) The purposes and powers specified in the clause contained in Article Second of this Certificate shall, except when otherwise expressed in said article, be in no wise limited or restricted by reference to or inference from the terms of any other clause of this or any other article in this Certificate, but the purposes and powers specified in each of the clauses of this article shall be regarded as independent purposes and powers, and the specification herein contained of particular powers of the corporation is not intended to be and is not in limitation but in furtherance of the powers granted to corporations organized under the Stock Corporation Law in pursuance of the provision of which this corporation is formed.

IN WITNESS WHEREOF, we have made, signed and acknowledged this Certificate of Incorporation this third day of July, 19—.

(Signatures) A. L. WITMAN
C. S. MEYER
P. B. THOMPSON

STATE OF NEW YORK }
COUNTY OF } SS.:

On this third day of July, 19—, before me personally came (*names of subscribers to Certificate*) to me known and known to me to be the individuals described in and who executed the foregoing Certificate, and they severally duly acknowledged to me that they executed the same.

.....

Execution and filing.—In New York and most other states the minimum number of incorporators signing the application is placed at three. It is also essential that each subscriber to the application set opposite his name the number of shares subscribed for. The incorporators must be of full age, two-thirds of them must be citizens of the United States, and at least one member a citizen of the state making the grant. This provision, of course, will vary in different states. Acknowledgment before a proper official is necessary as a prerequisite to filing.

As the next step, the original copy is sent to the secretary of state or to the office required by the particular state law. Another duplicate, original or copy, is required, in some states, as in New York, to be filed in a county office in the county containing the principal office of the organization as set out in the certificate.

Incorporation fees.—To offset the cost of administering the general corporation procedure it is customary to charge a fee of incorporation. The amount of such fee and other costs incident to filing are set forth in the following table.

ORGANIZATION TAXES AND FEES*

SHARES WITH PAR VALUE

Basis of computation.—Delaware: 1 cent per share to 20,000 shares; above 20,000, ½ cent per share; any number of shares aggregating value of \$100 or less computed as one share; minimum, \$10. New Jersey: 20 cents per \$1000; minimum, \$25. New York: 1/20 per cent of authorized capital stock (50 cents per \$1,000); minimum, \$10. Pennsylvania: 1/5 per cent of authorized capital stock (\$2.00 per \$1,000); charters providing for less than \$5,000 authorized capital will not be approved.

Authorized † Capital Stock	Delaware ‡	New Jersey	New York	Pennsylvania
\$5,000	\$10.00	\$25.00	\$10.00	\$10.00
6,000	10.00	25.00	10.00	12.00
7,000	10.00	25.00	10.00	14.00
8,000	10.00	25.00	10.00	16.00
9,000	10.00	25.00	10.00	18.00
10,000	10.00	25.00	10.00	20.00
15,000	10.00	25.00	10.00	30.00
20,000	10.00	25.00	10.00	40.00
25,000	10.00	25.00	12.50	50.00
50,000	10.00	25.00	25.00	100.00
75,000	10.00	25.00	37.50	150.00
100,000	10.00	25.00	50.00	200.00
125,000	12.50	25.00	62.50	250.00
150,000	15.00	30.00	75.00	300.00
175,000	17.50	35.00	87.50	350.00
200,000	20.00	40.00	100.00	400.00
250,000	25.00	50.00	125.00	500.00
300,000	30.00	60.00	150.00	600.00
350,000	35.00	70.00	175.00	700.00
400,000	40.00	80.00	200.00	800.00
450,000	45.00	90.00	225.00	900.00
500,000	50.00	100.00	250.00	1,000.00
750,000	75.00	150.00	375.00	1,500.00
1,000,000	100.00	200.00	500.00	2,000.00
2,000,000	200.00	400.00	1,000.00	4,000.00
3,000,000	250.00	600.00	1,500.00	6,000.00
4,000,000	300.00	800.00	2,000.00	8,000.00
5,000,000	350.00	1,000.00	2,500.00	10,000.00
10,000,000	600.00	2,000.00	5,000.00	20,000.00

* From material compiled by the Corporate Organization and Maintenance Department of Prentice-Hall, Inc.

† Minimum amount of authorized capital stock: Delaware, \$2,000; New Jersey, \$2,000; Pennsylvania, \$5,000.

‡ Compilation is for 100 par value shares.

**FEES PAYABLE TO SECRETARY OF STATE (OR SECRETARY OF
THE COMMONWEALTH OF PENNSYLVANIA) ON FILING
INCORPORATION AND OTHER PAPERS⁴**

	DELAWARE	NEW JERSEY	NEW YORK	PENNSYLVANIA
Certificate of incorporation..	\$6.50 (a)	(e)	20.00	\$30.00
Amendment of certificate of incorporation, not other- wise specified	16.50 (a)	\$20.00	20.00	10.00
Change of location of prin- cipal office	5.00	5.00	20.00	10.00
Change of name	16.50 (a)	20.00	20.00	20.00
Change of number of direc- tors	(b)	(b)	20.00	(b)
Change of par value of shares	16.50 (a)	20.00	20.00	10.00
Change of par value shares to non-par value	16.50 (a)	(g)	(o)	(k)
Change of registered agent..	11.50 (a)	2.00	20.00	(b)
Classification of capital stock	16.50 (a)	20.00	20.00	(b)
Consolidation or merger	(c)	(f)	25.00 (m)	55.00 (j)
Decrease of capital stock.....	16.50 (a)	20.00	20.00	30.00 (l)
Dissolution	22.50	20.00	5.00	10.00
Increase of capital stock.....	(d)	(h)	20.00 (i)	30.00 (l)
Payment of capital stock.....	5.00	1.00	(b)	10.00
Report to secretary of state...	2.00	1.00	(b)	(b)
Foreign corporations:				
Certificate or statement....	20.00	10.00	50.00 (n)	10.00
Change of name.....	(b)	(b)	20.00	5.00
Change of resident agent..	12.00	3.00	(b)	(p)
Change of registered office	(b)	1.00	No fee	5.00
Report to secretary of state	(b)	1.00	(b)	(b)
Surrender of authority....	5.00	1.00	20.00	5.00

- (a) \$6.50 of this is for receiving, filing, and indexing certificate and certifying copy.
(b) Not required.
(c) Apply increase of capital stock over combined authorized capital stocks to table on page 87, for no par value shares one-half of fee as shown by table.
(d) Apply increase to table on page 87, for no par value shares, one-half of fee as shown by table.
(e) No fee in addition to that stated in table on page 87 except the usual recording fee.
(f) Twenty cents per \$1,000 of capital authorized beyond total authorized capital of corporations consolidated or merged; minimum, \$20.00.
(g) One cent per share for shares without par value created, with credit for original filing fees paid; minimum, \$20.00.
(h) Twenty cents per \$1,000 of total increase authorized; minimum \$20.00.
(i) In addition to tax payable to state treasurer of 1/20 of one per cent (50 cents per \$1,000) of increase as to shares with par value and 5 cents per share as to shares without par value.
(j) And \$5.00 additional for certificate of each secretary attached to agreement.
(k) No statutory provision for this change except upon reorganization or consolidation.
(l) \$35.00 if publication and notice are waived. Bonus on increase payable only when increase actually made. Fee for filing return of actual increase or decrease, \$5.00.
(m) Also tax payable to state treasurer of 1/20 of one per cent (20 cents per \$1,000,

⁴ *Ibid.*, p. 340.

or 5 cents per share in the case of shares without par value, upon the amount of capital stock in excess of the aggregate amount of the capital stock of the consolidated corporations.

- (n) Also \$2.00 for issuance of certificate of authority.
- (o) As to tax payable, see page 115 of this book.
- (p) No change can be made, as secretary of commonwealth is the resident agent for service of process in all cases.

A second type of requirement as to execution and filing may be found in the state of Illinois. Articles of incorporation similar to those employed in New York are drawn up by the incorporators, signed and acknowledged and submitted to the secretary of state with the proper fees, whereupon a license to organize is issued. An effort is next made by the incorporators to secure subscriptions to the entire amount of the capital stock to be issued, and if they are successful a subscribers' meeting is called. At this meeting temporary officers and permanent directors are elected, the directors holding their first meeting as soon as possible thereafter. At the directors' meeting permanent corporate officers are elected and by-laws are adopted. When this has been accomplished, a written report of what has been done is sent to the secretary of state, where it is placed on file and a charter issued to the incorporators authorizing them to begin business within two years from the date of the charter.

Incorporating Service.

Service companies have been organized to assist incorporators and their attorneys in the process of organizing a new corporate enterprise. Prentice-Hall, Inc., is a typical example. They deal with lawyers only and act for them as an experienced clerk or assistant. They do not guarantee their services, but ordinary business prudence is sufficient to make them adhere strictly to a course which conserves the lawyer's best interests. Added to this is the policy of these companies never to assume the relation of counselor or adviser. They furnish data on which the lawyer may rely in reaching his conclusions, and attend to time-consuming details, but do not attempt to usurp the lawyer's place in forming judgment on legal questions.

Prior to organization, they furnish a synopsis of the

corporation laws of the state in which the organization is to be created; a statement of the organization costs including organization fee, filing fee, and franchise and other taxes. They also draft the certificate of incorporation or charter and file it with the proper state and county officials; hold the first meeting of the incorporators or stockholders; and assist attorneys wherever possible.

Subsequent to organization, they maintain the office required by statute, furnish the resident agent, and display the sign necessary to keep the corporation in good standing and to avoid a possible forfeiture of the charter; give the attorney notice of every state report that must be filed and tax which must be paid; deliver to the attorney all papers served upon the resident agent, officer, or director, giving telegraphic advice when necessary.

Problems.

1. A corporation is organized in the State of New York for the manufacture and sale of artificial honeycombs. Draw up a charter where the authorized capitalization is to be \$450,000 preferred stock and \$275,000 of common.

2. Explain the procedure necessary to the formation of such a corporation.

3. How much organization fee would be charged in the State of New York? In Delaware? In New Jersey? In Pennsylvania?

4. Compare the charges in each state if only two-thirds of the stock authorized in the charter is to be issued at the time of organization.

5. Compare the partnership agreement and the corporate charter in content and scope.

CHAPTER VII

THE CORPORATE CHARTER: NAME AND PURPOSE

In the certificate of incorporation reproduced in the preceding chapter as a typical example of one containing the usual provisions, the clauses fall into the following classification:

Name of the corporation.

Purpose for which it is formed.

Capitalization.

Location.

Duration.

Provisions as to stockholders.

Provisions as to directors.

Analysis of the name and purpose clauses in the charter will be made in the present chapter, subsequent chapters dealing with the remaining clauses.

The Corporate Name.

In any form of business enterprise great importance should be attached to the selection of a name. This is true from the standpoints of both business and legal requirements. It is customary for the promoter or incorporators organizing a new enterprise to supply their attorneys with a list of four or five possible names in the order of their desirability, the next available one being used in case the most desirable selections are not available, due to something similar having been previously chosen by another corporation. Exhaustive investigation may be necessary to determine whether or not the choice of name may infringe upon the rights of another

enterprise using the same name, any duplication being unwise from both the business standpoint and the legal requirements. Frequently, and wisely, this service is placed in the hands of corporations specializing in such work and maintaining offices or agents throughout the country, such as Prentice-Hall, Inc., of New York City. The work of these services was described in Chapter VI.

Legal requirements as to corporate name.—The secretary of state will refuse to approve the articles of incorporation where the name is deemed to be too nearly like one already in use or which is in any way misleading or confusing. In a good many states, corporations, or any enterprise affording limited liabilities to members, are required to designate the nature of the situation in the name used in conducting the business. In New York, for example, the law requires that a corporation use the term “incorporated” or “corporation” in its name, as the Brown, Jones Company, Incorporated, or the Brown, Jones Corporation. Some states require the body of the name to be preceded by the word “The” and followed by the word “Company.” Where these safeguards are not required the name indicates nothing as to the true nature of the enterprise. Where they are used, creditors and other interested parties have ample notice of the actual liability of the enterprise and members making up the organization. Absence of regulations specifying rules for name structure in any state constitutes a serious neglect of the citizens of that and other states, which should be remedied without delay.

One or two illustrations will serve to emphasize the nature of these legal requirements. In a recent case, an injunction was sought restraining the Muench-Baumer-Kreuzer Candle Company, Inc., from using the term “Baumer” in its company name, the plaintiff being the Will & Baumer Candle Company, Inc., of Syracuse, New York. The action also demanded \$50,000 damages against the new corporation which was recently organized. The Will & Baumer Company maintained that the name Baumer was employed to confuse the trade which it had built up throughout the United States, Canada and other parts

of the world. They insisted that the name Baumer had been an important factor in building up their business with an annual sales figure of \$2,500,000. The injunction application asked the court to compel the new firm to drop the word from its trade name, its labels, and its advertising. In order to avoid litigation the defendant voluntarily changed its name, dropping the word "Baumer."

A recent Oregon decision furnishes an additional illustration. The Umpqua Broccoli Exchange brought suit in the Oregon Supreme Court to prohibit the newly incorporated Um-Qua Valley Broccoli Growers, who had been a partnership for a number of years, from using the name adopted, although the name had been carried over from the partnership days. The court decided that the defendant company was not barred from the use of its name since they were the first to use it and become known by it, and therefore could not be denied the right to incorporate under the name because others had preceded them in incorporating under it. The courts further stated that any damage resulting to those first incorporating was chargeable to their folly in choosing a name already in use.¹

Had the defendant company not made previous use of their name it is probable that the plaintiff could successfully have defended their right to its exclusive use.

The corporate name from the business standpoint.—From a business standpoint, the corporate name should be conveniently short and indicative of the general nature of the business. At any rate, the name chosen should be one around which good-will may be built through good service and extensive advertising policies. Frequently this good-will is built around the name of the individual who is the prime mover back of the organization, as in the case of Ford, Wanamaker, Marshall Field and Edison. Again, an abstract name may be chosen such as the Standard Oil Company, The Champion Coated Paper

¹ The Umpqua Broccoli Exchange v. Um-Qua Valley Broccoli Growers, 245 Pac. 324.

Company and The Victor Talking Machine Company. In forming a new company, however, it is well to avoid the use of the more or less hackneyed general terms such as Standard, Victor, National, Union or American. As a third possibility, use is frequently made of names indicating geographic importance, width of market, or enormous size. Examples of this usage are found in such company names as United States Steel, Atlantic and Pacific Tea Company, The American Tobacco Company and so on indefinitely. Much used geographic names are, however, to be avoided both from the legal standpoint and the standpoint of business expediency.

Frequently, large corporations build good-will around a trademark or brand of product, such as Hammermill Bond, Arpeako Hams made by the Rochester Packing Company, Incorporated, etc. In such cases the importance of the corporate names may be diminished to a large degree.

It will be discovered later that great difficulty is attached to amending a corporate charter in order to change the name of an organization, so that the original name chosen, and once adopted, must be maintained unless sadly inadequate. It may be simpler to form a new corporation having the new name and taking over the assets and liabilities of the old concern, than to attempt to change the name by amendment.

Where a partnership changes to a corporation it is wise to adapt the old partnership name to the new corporation, in order that whatever good-will or public confidence has been established may be carried over to the new concern. This may be done very simply by taking the body of the partnership name and inserting the terms indicative of the true nature of the limited liability of the enterprise. In New York this would require the introduction of the term "Incorporated," following the old name or the inclusion of the term "Corporation" within the body of the name. In other states the requirement may take the form of prefacing the old name with the term "The" and concluding it with the term "Company."

These intangible values are in some cases equal to or even greater than the total property values, and are frequently included in the financial statements of the accounting department of a going concern. They are even frequently included in the sale price where a company sells out to another party.

In view of the observations made above concerning the importance of the selection of the corporate name, it becomes evident that too much emphasis cannot be placed upon the virtue of fulfilling the legal requirements of the various states, or upon the importance of subscribing to the business requisites.

The Purposes for Which Corporations May Be Formed.

Because the corporation is the recipient of special rights and privileges, granted in the charter secured from the state, it is subject to certain limitations with respect to the activities in which it may engage. These limitations are designed to protect the stockholders, the creditors, and society in general, where corporate activities might result in harm to any of these groups.

It may be said in the beginning that, while the corporation is a legal entity, that is, equivalent, in most respects to a human individual, it is not permitted to engage in business with the same freedom accorded to a real person. However, so long as they are legal, the corporation may engage in the activities directly specified in the certificate of incorporation, and in addition has certain implied powers similar to those granted to any real person. After deciding to incorporate, it is very essential to determine exactly the scope of activities desired and to see to it that there is no danger of being too narrowly limited in the statement of purpose. Even at best, the the corporation finds itself in a position where it is accused of either illegal activities, that is, activities that would not be tolerated even where practiced by a real person, or *ultra vires* acts, which are acts legal in themselves but not within the scope of the purpose clause of the charter. Incorporating for the purpose of distilling liquors would

be an example of illegal purpose. If a corporation organized to run a retail butcher business contracted to purchase two tame elephants, such an act would be called *ultra vires*. These activities will be discussed more fully in a moment.

Implied Corporate Powers.

A corporation is not necessarily confined, in its business activities, to the concrete purposes set forth in the charter, although these statements of purpose are of great importance as will be seen in a moment. In addition to the specified powers granted by the charter, a corporation may have power, by virtue of its position as a legal entity, to do anything that a natural person may do. The most common of these implied powers usually conceded to a corporation are:

1. Power to contract.
2. Power to borrow.
3. Power to buy and sell property.
4. Power to make by-laws.
5. Power to make assignment for the benefit of creditors.
6. Power to acquire its own shares of stock.

On the other hand, a corporation may not, under its implied powers:

1. Make or endorse accommodation paper.
2. Lend money or extend credit.
3. Acquire shares in other corporations.
4. Enter into partnerships.

Power to contract.—Since the corporation is a legal entity, contracts made by it should be made in the corporate name and conveyances of land may be made similarly. Likewise, the sale of land by the corporation should be executed by it in its corporate name. But the corporation as a legal entity has no brain to guide its actions, and no hands to execute its decisions, and must consequently carry on its business through human agen-

cies. Corporate contracts must, therefore, be entered into upon due authority. For example, when the state authorizes a corporation to build and operate a theater and it contracts for a thousand yards of silk, such a purchase is without authority granted to the corporation. In the second place, the contract must be made on behalf of the corporation by an authorized corporate officer or agent. Thus, should a brakeman on a railroad contract in its interests to purchase steel rails, the contract is not binding for the brakeman had no authority to bind the corporation on such a contract. The third test is concerned with whether or not the contract was made in the proper form and in accordance with the provisions of the state laws, or charter and by-laws of the corporation. Suppose, for example, that the statutory provisions require that corporate contracts be signed by both the president and secretary of the corporation. These provisions must be observed. If they are not, the contract is not made pursuant to the statutes. Suppose that corporate contracts must be made under seal. A contract not under seal is void. Finally, contracts must be legal; that is, not against public policy. In this respect, the problem of contracts is the same for both corporations and real persons, and consequently needs no further analysis. The methods of carrying out corporate business will be better understood after a detailed study of the mechanism for corporate control through stockholders, directors, and officers.

Power to borrow.—The corporation has implied power to borrow money and to issue promissory notes. Its position in this respect differs from that of the human individual in that its borrowings must be for legitimate corporate objects and within any limits placed by state laws. Otherwise, a corporation may borrow as much as its credit will permit. A corporation may also mortgage its property.

Power to buy and sell property.—There seems to be little doubt of the implied power of a corporation to buy and hold real property in its own name. In general, it may be said that real property may be acquired in the corporate name only in amounts absolutely necessary for

the successful conduct of the enterprise. This limitation has grown up owing to the fact that corporate life is essentially permanent and the corporation might, at least theoretically, acquire sufficient land to become more powerful than the state itself.

Usually a corporation has no implied power to sell the whole of the real property belonging to the enterprise without the consent of all of the stockholders. Otherwise the corporation would be practically dissolved at the will of the directors and without the consent of the owners. In cases where a corporation is in financial difficulties, bordering on failure, it is sufficient that a majority of stockholders vote to alienate all the property and close out the business in order to protect the stockholders against further loss.

Power to make by-laws.—The internal control of a corporation is effected through a set of rules known as by-laws which the corporation has the implied power to make. Usually they are made and altered by the stockholders, but in some cases the power is delegated to the directors. These by-laws apply only to the internal affairs of the corporation and consequently may not affect third parties. A minute analysis of the by-laws will be made in a future chapter.

Power to make assignment for the benefit of creditors.—The corporation has the same right to make an assignment for the benefit of creditors as an individual.

Power to acquire its own shares of stock.—The weight of authority in the United States seems to hold that a corporation may acquire its own shares in legitimate ways, where done in good faith without injury to any creditors. Where injury to creditors results, or any fraud is practiced, the transaction is illegal. Sometimes it is held that it is legal for the corporation to acquire its own shares if it does so through the use of accumulated surplus, but illegal to do so by expending capital funds.

Certain acts usually permitted to an individual but denied to the corporation were listed above. Brief discussion of each of these prohibitions is necessary to

round out the thought concerning the implied powers of the corporate form.

The prohibition against making or endorsing accommodation paper.—The law assumes that a corporation, like all types of business enterprise, is formed to engage in business for the distinct purpose of making profits for the stockholders. Where the corporation departs from its main function by accommodating third parties at the risk of loss of stockholders' property, it is obviously going beyond reasonable activity. An individual endorsing notes has only his own wealth at stake, while the corporation as an entity occupies a position similar to that of a trustee, with the stockholders playing the part of beneficiaries to the trust. Should all stockholders agree, however, there seems to be no objection to permitting the corporation to make or endorse accommodation paper, such as promissory notes.

The prohibition against lending money or extending credit.—This prohibition is not universal or well established. As a general rule, however, it is well to consider that a private corporation has no implied power to lend money or extend credit in the way in which banks and other financial institutions do. The reason for this prohibition is the same as that against making and endorsing accommodation paper, discussed in the previous paragraph. Certainly, however, a corporation must extend credit to its customers. It may, in some cases, go still farther, as in the instance of an Illinois brewery which was permitted to lend money to a saloon keeper for the purpose of erecting and operating a saloon and public hall where its beer would be sold. 12715

Acquiring shares in other corporations.—As a general statement it may be said that there exists no implied power for a corporation to acquire shares of stock in other corporations. This prohibition rests partly on the danger involved in permitting one corporation to secure control of the management of a number of corporations through stock ownership, with the possible result of monopoly or restraint of trade. Commonly, however, such stock acquisition is prohibited even as an invest-

ment. Of course, where corporations are compelled to take stocks of another corporation to safeguard the payment of a debt owed by another organization the prohibition does not apply. We shall see later that some states have modified this common law rule to permit of more latitude in this respect.

The corporation cannot become a member of a partnership.—Most persons competent to make contracts are permitted to become members of a partnership. The fictitious person, the corporation, is rightly denied this power where not authorized by statute. It may be well to restate here that each member of a partnership may bind the firm and other members. Should a corporation be permitted to become a member of a partnership, it could be bound by the acts of any other corporate members of the partnership, resulting in a condition by which the affairs of the corporation would be placed under control of persons outside of its own directing group. Thus the corporation's duty to its stockholders and to the state would be violated. One of the corporation's chief virtues is its centralized and responsible management through its board of directors. Any diminution in this virtue would be fatal to the integrity of corporate enterprise. Thus, there seems to be no argument favorable to permitting one corporation to associate with others as a partnership enterprise. We shall see later that the early trusts, in which competing corporations acquired more or less control of their field of endeavor through a pooling of their voting stock in the hands of a trustee, were condemned in some cases as being partnerships of corporations, thus indulging in *ultra vires* acts.

There can be little doubt that the four prohibitions just discussed, designed to protect the stockholders, creditors, and the state granting the charter, are legitimate and necessary. The principles involved will continually appear in practical application to problems discussed in the future chapters, especially in the consideration of the types of enterprise involving intercorporate relationships.

Specific Corporate Powers Granted by the Charter.

Besides the implied powers discussed above, the corporation may engage in activities specifically defined in its charter granted by the state. For instance, the exact nature of the business to be exploited must be stated, and a corporation has no power to engage in any other separate business not provided for in the charter, although, as we have seen, certain activities may be engaged in where they directly promote the interests of the business and the stockholders. On this ground, a manufacturing company could not engage in the real estate business, nor could a merchandising company engage in the railroad business. There is little restriction placed upon the purpose which may be designated in any corporate charter excepting that the ordinary industrial or commercial charters cannot bestow powers usually reserved for financial institutions, such as banks, and the public utilities, such as street car companies. These classes of corporations are formed under special incorporation laws.

Single purpose charters.—Originally, the prevailing practice demanded that the statement of purpose in the charter be confined to one activity only, with the general activities necessary to carry out the specific endeavor. For example, mining companies developing one kind of mineral deposit could not exploit any other form of mineral, nor could a corporation formed to cut timber operate a mill or lumber yard. A new corporation must be formed to carry on these latter activities as the old corporation charter did not cover these pursuits. In a few states this practice is still a modifying factor, as in Illinois where the scope is limited to only one kind of business or an affiliated business. In general, charters are permitted to be more comprehensive under present statutes. Occasionally, however, it may be advantageous to restrict the corporate activities to a specific purpose. Thus, where a partnership is to be incorporated, it may be advisable to limit it to the purpose of the business already being carried on. Such a requirement would prevent any subsequent diversion of the stockholders' resources into

other and possibly unprofitable activities. The new corporation should be permitted to conduct the one business and only the one.

Charters having broad powers.—In current practice, it is possible for a charter to specify a great variety of activities in which it intends to engage. In fact, the purpose clause of any charter may be, and usually is, the most extensive single provision. Adequate proof of this assertion is contained in the model charter reproduced in Chapter VI. This verbosity is due, in part, to the fact that it has been the desire of the organizers to play safe by including many powers which might be implied as existing even though not stated in the charter, and in part to the habit which lawyers have of employing superfluous language. Some day some courageous attorney may have the temerity to break away from legal custom and produce a simple, but comprehensive, charter which is less confusing than those at present in use, especially as it pertains to the statement of the corporate purpose.

Prohibited corporate purposes.—It has been a general policy to prohibit the professions of medicine and law from incorporating. This denial of corporate rights is based upon the idea of the impersonality of the fictitious personage of the corporation, which, being artificial certainly could not diagnose cases and prescribe remedies, or plead cases before the bar. Such argument could, however, be extended to any activity, denying incorporation to all enterprise.

Illegal purposes and ultra vires acts.—When, by any chance, a corporate charter is formed for a purpose which proves to be illegal or immoral, when the activities are against public policy, the corporate relationship is non-existent and the shareholders take the position of partners in a partnership with unlimited liability in case of insolvency. This fact necessitates great care on the part of the organizers of a corporation and upon stockholders in determining the authority for the powers being exercised, or to be exercised by a particular enterprise.

Ultra vires acts, legal in their nature, but not included within the purpose clause cannot be indulged in by the

corporation. Stockholders have the right to object whenever they feel that their interests are jeopardized by prosecution of activities not mentioned in the charter. Both illegal and *ultra vires* acts have lost something of their importance under the comprehensive theory of corporate purposes. Probably the most outstanding application of the *ultra vires* principle in recent years was against the trusts, where several corporations delegated their prerogatives, by placing the voting stock in the hands of a trustee who would thus control the policies of several corporations. One of the early prosecutions of the trusts, that against the Standard Oil Company, was based upon this idea.

When a corporation goes beyond the powers granted in the charter, or implied in common law, it becomes possible to hold the directors and officers personally liable in case of injury to creditors or stockholders resulting from such actions.

Problems.

1. Classify the factors entering into the choice of a corporate name.
2. (a) From the financial page of your daily paper select five corporations having names indicating the "persons" making up the organization.
(b) Select five having abstract names.
(c) Select five having geographic names.
3. In each case above, does the name signify the exact nature of the business?
4. What is the difference between the business name and a trade name?
5. Distinguish between implied and specific purposes which a corporation may pursue. Discuss each.
6. Compare illegal and *ultra vires* acts giving examples of each.

CHAPTER VIII

THE CHARTER: CAPITALIZATION

By capitalization is meant the securities, whether stock or bonds, issued by a corporation in exchange for cash, property, or personal services rendered to the corporation. Such a definition is more inclusive than legal practice and, in some cases, accounting practice, would permit, but it is not without merit when used in a more general business application, since necessary capital may be recruited by either stock or bond issues, whether the concern is newly launched or is an old, going concern. The certificate of incorporation sets out in detail the capitalization scheme determined upon from the standpoint of authorized stock issues, and may also define the authority of the directors in the matter of borrowing through bond issues, or otherwise. After the necessary amount of capital has been determined upon, the promoter or incorporators, or, in case of a going concern, the directors, are compelled to consider the relative merits of stock and bond issues, consideration hinging largely on the condition of the security market.

The Nature of Stock.

When the investor places his money or property in the hands of the corporation to be used in productive enterprise he receives in exchange a document in the nature of a receipt which forms a convenient evidence of ownership and which makes possible the easier transfer of his shares to other parties, as will be discovered later. The certificate of incorporation usually classifies stock into "preferred" and "common." Preferred stock has no inherent preference, but is actually like common stock

except as modified by the charter provision. These modifications usually affect:

1. Dividend payments.
2. Voting rights.
3. Distribution of assets upon liquidation.

Preferred dividends.—No stock has preference as to dividends unless it is so provided in the charter. This preference is so common, however, that it has come to be considered as almost an inherent right. The provision usually states that preferred stockholders shall receive their share of profits at a fixed rate, say 6% or \$6 a share when par value is \$100, before any distribution of profits is made to the holders of common stock. In case each class of stock has received equal dividends, say 6%, any additional surplus profits are shared equally unless the charter makes other provision, such as limiting preferred stock to 6%, the entire remainder going to the common stockholders. Such limitation might be termed a negative preference: it subtracts from rather than adds to the advantage of so-called “preferred stock.” Likewise, denying other classes participation in excess profits makes common stock more speculative. Frequently, as a result, common stock is quoted higher on the market than preferred. It is usually the common stock, therefore, which produces somewhat sudden acquisition of small or large fortunes while preferred stock presents greater regularity and safety.

When stock is preferred as to dividends these dividends are automatically cumulative if no provision is made to the contrary. That is, if the rate of annual dividend specified for preferred stock is not available any given year, the amount cumulates in favor of the stock and must be paid in the future before any profits may be distributed to common shares. For example, if one holds a \$100 share of preferred stock in a corporation and it has a 6% preferred dividend rate and the corporation makes no profit for the current year the share must be allowed a 12% dividend next year, in case profits are available, before common can share in profits. If the cumulative

feature is to be eliminated, it must be so stated in the charter and the provision will find expression on the face of the stock certificate.

Voting rights.—Common stock and preferred stock possess equal rights in the matter of voting. Frequently, however, the voting right is denied to the preferred shares and retained for the more speculative interests. The vote cast in the meetings of the stockholders, is the only means of participation in determining the policies of the enterprise since, by the very nature of the corporation, most of the power of running corporate affairs is delegated to the board of directors; for if the stockholders retain a voice in the management, the corporate form would lose a large part of its advantage over the partnership, and would have as many “bosses” as it had members, membership sometimes running as high as 200,000 share owners. Sometimes, as in the charter under discussion, preferred stock is denied the right to vote except when the board of directors has been unable to declare dividends for a specified length of time. The rights and powers of the stockholders will be considered further in a later chapter. Other special voting provisions will be discussed in Chapter X.

Liquidation of assets.—When a corporation is dissolved or for any reason the property is sold, the debts of the organization are paid off, and any balance remaining is distributed equally between common and preferred stock. Frequently, however, preferred stock reserves the right in the charter to share in such a distribution up to the total of its face value before common shares receive any return. This is called preference as to assets.

The total amount of stock to be issued is divided into proportional units, each being given a *par value*. That is, if the capitalization is to consist of \$100,000 it might be divided into 1,000 shares each having a par value of \$100, or 2,000 shares of \$50 par value each. One certificate of stock may contain evidence of ownership of any number of shares.

Stock without par value.—In states where laws have been passed permitting the issue of stock having no par

value, such a device has been quite commonly used. Since 1912, when New York state passed a law granting this right, other states have passed similar legislation until more than half of the states in the union have such laws. Owing to the increasing use of no-par stock we may well consider briefly its nature, advantages and disadvantages.

The nature and advantages of no-par stock.—At best, any share of stock represents simply the interest of the owner in the property and income of the corporation. In as much as these factors, measured in dollars and cents, vary from time to time, so must the monetary value of the shares of stock vary, and a designated par or face value may be deceptive when such value and the asset value differ. It is argued by advocates of the use of no-par stock that this deception may be reduced or eliminated when stock with no nominal value is substituted for par value stock. To illustrate, it is quite commonly believed that, when one buys a \$100 par value share for \$75, he has made a \$25 bargain, when, as a matter of fact he succeeded in getting the stock for \$75 only because that is all it is worth from the standpoint of asset and income value. In this respect, stock is unlike the bond, for in the latter the face value and the actual value more nearly correspond.

In the second place, statutes have required that stock *with* par value be sold and fully paid for in cash or property or, to reverse the statement, that no par-value stock be sold below par. To make stock attractive, corporations have had to resort to the use of bonus stock, that is, the *gift* of a full paid share with the *purchase* of each share. The evils of overcapitalization and stock watering have arisen largely out of this practice.

These same evils are likely to prevail when full paid par value stock is issued in exchange for property. That is, the property is overvalued in order to make the par stock "full paid," in obedience to the law, resulting in fraudulent book entries and consequent overcapitalization.

To summarize, no-par stock tends to prevent fraudulent stock sales and to reduce self deception, to facilitate the

issue of stock in exchange for property, to simplify to some extent the accounting records, and to permit of the sale of stock at any price.

Disadvantages of no-par stock.—The purchasers of stock have so long dealt on a par value basis that stock without a specified money value may at first, and in some cases, be difficult to sell. With the increase in its use, however, the public should be willing to absorb it with little objection.

Within the corporate accounting offices there seems to have been some little difficulty in adjusting the procedure so as to adequately adjust the accounting system to the use of no-par stock, and some lack of uniform method in its treatment on the balance sheet or on the books. For example, it may be carried at a value corresponding to the issue price; at an arbitrary fixed value; at its actual value, found by dividing the net worth by the number of shares issued; at the price quoted on the market; or in accordance with some other valuation.

State tax laws have had to be modified for adjustment to the situation. Some have taxed shares as though they had a \$100 par value, a policy which means almost no adjustment, while others base taxation on actual or issue value.

Issuing corporate stock.—Not all of the stock authorized by the charter need be issued at the time of organization, the amount withheld being termed *unissued stock*. The nature of this stock is frequently confused with that of *treasury stock*, which has found its way back into the possession of the corporation through gift or purchase, after having once been issued.

It is frequently required by state statutes that the corporation does not begin business until a certain minimum of the stock has been subscribed for, and in some cases until a minimum amount of money has been paid in on the subscriptions. Delaware, for example, requires a minimum subscription of \$1,000 or 10 shares where stock has no par value, but has no minimum payment requirement. Illinois, by way of contrast, requires that

one-half of the capital stock which it is proposed to issue at once be paid in before beginning business. A few states also specify a minimum of stock which may be authorized, the figure being set, usually, at from \$500 to \$2,000.

The Nature of Bonds.

Bonds form another source of capital. When an individual loans money to an enterprise he receives in exchange a document similar to a promissory note, which is evidence that he has loaned money, and this document is called a *bond*. Like a share of stock it may be bought and sold on the market but, unlike stock, it usually has no participation in the management of the company in which it is invested. Whereas the stockholder is a proprietor or owner, the bondholder is merely a creditor. The bond differs from an ordinary promissory note in that it is executed under seal, has a relatively long time to run to maturity, and is usually a specific lien on corporate property. As in case of any debt, interest must be paid on bonds, whatever the financial condition of the corporation. In case of default in the payment of interest or principal when they fall due, bondholders may bring action to collect their just dues, usually by the process of foreclosure.

Authority for corporate borrowing.—Like any legal entity, the corporation has the right to borrow. Where statutes make no provision for this, the authority lies in the hands of the board of directors, without any reference to permission of the owners or stockholders. In some states, statutes have limited the borrowing power, requiring a majority or two-thirds vote of stockholders consenting to the loan. In common practice, however, it is better business policy to permit flexibility in borrowing, with little statutory interference, although some protection may be afforded through permissive by-law or charter limitation. In Illinois, protection to stockholders is secured by statutory provision sufficiently flexible to permit of unlimited borrowing but making directors and officers liable for debts in excess of the

amount of capital stock, while Arizona prohibits indebtedness in excess of two-thirds of the amount of capital stock.

Kinds of Bonds.

In order to adjust the nature of borrowing to the financial condition of the company, or to create attractive features for bringing lenders of money into the market, a great variety of terminology descriptive of bonds has sprung up. For convenience, we may classify bonds into (1) secured bonds, and (2) unsecured or debenture bonds, the former being the more common in the United States, while the latter have been more widely used in England. The commoner terms used in connection with secured bonds merit brief definition.

Secured bonds.—The security back of the first class of bonds may be the entire corporate property, in which case it is said to be a *general* mortgage bond, or it may be a *special* mortgage bond. Mortgage bonds are sometimes defined in order of priority as *first*, *second*, etc., mortgage bonds. Sometimes a corporation may have possession of securities of outside or subsidiary companies which may be used for security behind bond issues, such issues being designated as *collateral trust bonds*. *Equipment trust bonds*, usually used by railroads, have as security corporate equipment, such as railroad rolling stock. Frequently a holding company guarantees the bonds of a subsidiary, to which class the name *guaranteed bonds* is given.

Interest upon bonds is usually paid on a straight percentage basis, but frequently they are made more attractive by providing for participation in income exceeding a sufficient amount to pay the stipulated percentage rate of dividend on stock and interest on bonds. Occasionally, in case of reorganization, where it is desired to reduce the fixed charges, bonds bearing a stated rate of interest are exchanged by bondholders for new bonds depending upon the earnings of the corporation for their return, much in the same manner as stock secures its portion of earnings. However, bondholders usually pre-

fer this procedure in preference to receiving stock, since their prior lien over stock is maintained.

The interest and principal may be made payable in gold, silver, or legal tender money. Where no specification is made in this respect, any legal tender is assumed to be acceptable. If the principal is to be paid off in a lump sum at the expiration of the time for which the issue is to run, the sum having accumulated over the period of years in the form of a sinking fund, the bonds are called *sinking fund* bonds; whereas *serial* bonds are redeemed on the installment plan by paying off a fractional portion each year, say one twentieth at the end of each year for twenty years, in case they are to mature over that period of time.

Modern financial practice has introduced a new point of view on the part of directors. In the earlier days, before the use of credit had reached its present proportions, debt was looked upon as something to be reduced or eliminated as soon as possible. Frequently capital was raised by the use of stock, borrowing through bond issues being a last resort measure. This was due to the fear of having fixed charges resulting from the necessity of paying recurring interest debts. Sinking funds were created, and added to each year, for the purpose of having sufficient funds available for retiring the bonds when they became due. Modern finance has tended to accept a changed point of view. Money is now secured through the issuing of bonds, the directors having no intention of retiring them at their due date by repayment. Rather, the debt will be renewed and continued by the issue of new bonds to take the place of those falling due. This changing view is probably due to the fact that modern credit is based, in a large measure, on the integrity of the enterprise and on its continued favorable earning power, rather than on destructible physical assets.

The new practice has been most noticeable in the development of the transportation industry. It is now common for railroads to replace maturing bonds with new ones rather than to retire them by cash payment. The change has also been more noticeable among the

newer industries and in sections where tradition has not dictated a policy of clinging to old financial customs.

It is still essential, however, that some ratio be maintained between the amount of borrowed money and invested capital or, in other words, that capital be recruited by bringing in owners on the one hand and creditors on the other in the proper proportion in order to keep fixed charges at a safe minimum.

Creating the trust in bond issues.—In mortgage bonds the procedure is similar to that involved when an individual gives a mortgage on real property to secure a loan. Individual mortgage lending involves the giving of a bond promising future payment which is backed by a mortgage on real property. The corporation, however, instead of giving each of a multitude of lenders a separate bond and mortgage, breaks the bond into numerous smaller units to be offered to investors while the blanket mortgage covering all of the individual bonds is placed in the hands of a trustee under a trust agreement, known as a deed of trust containing the covenants governing the trustee relationship, and protecting the bondholders. This agreement usually recites:

1. The date of the mortgage.
2. The names of the parties.
3. Authorization of bond issue by stockholders and directors.
4. A granting clause, transferring the property to the trustee.
5. A description of the property.
6. A declaration of trust containing covenants of the corporation in the matter of insurance, taxes, maintenance, remedies in case of default, etc.

Where the security is personal property as in the case of collateral trust bonds, such property is deposited with the trustee under a trust agreement, defining the conditions under which the trust is formed.

Borrowing without specific security.—Debenture bonds, issued for the purpose of securing increased working capital, are issued on the general corporate credit, rather

than on specific property, and are mere promises to pay at a future date the sum borrowed. Upon default in the payment of interest or principal they may be the basis of suit but, having no claim of specific corporate real property, they cannot be the basis for foreclosure. Debentures take priority over stock, their status otherwise being defined in the trust agreement. Obviously, directors can float such loans only when the credit of the corporation is high, and when the interest rate is sufficiently high to attract investors.

Short time loans are secured by the issue of promissory notes, which do not form a part of the so-called capitalization structure and therefore need not be considered here.

The Security Market.

At certain times or under certain conditions it may be impossible to sell stock to the public, whereas bond issues may be readily absorbed when offered. For example, the unfavorable position of the railroads after the Great War, further aggravated by the "recapture clause" of the Transportation Act of 1920, requiring railroads to share earnings above a modest rate of return with the government, helped to make it impossible for this industry to raise sufficient capital without resorting to borrowing by the issuing of bonds. Likewise, when money is scarce and safety of investment is required by the investor, the use of a bond issue may be the chief source of capital supply.

In considering the wisdom of bond issues, however, the directors must keep before them the dangers involved in such an expedient to accommodate their capital accumulation to market conditions. One current writer remarks, in this respect: "if the income of the company is fluctuating, the losses in lean years will be increased by the burden of interest payments, just as the gains in prosperous years will be magnified by the increased earning of the borrowed capital. The possibility of a receivership as the result of default of interest payments may outweigh the probable advantages of the bond issue.

Again, unless the borrowed funds can be profitably employed in maintaining economically an organization that can properly coördinate the business functions—a condition, it is true, which seldom obtains in well-managed corporations—a bond issue would not be advisable. A further obvious limitation upon the utilization of borrowed funds is the potential market for the product. If the result of increased production will be to overstock the market and lower the price of the goods to an unprofitable level, the advantages of a bond issue would be negated. Another factor which acts as a brake on borrowing is the fact that successive sums must usually be obtained at higher rates of interest because of the increasing risk to lenders. A third mortgage, which may apparently hold as good a position as a first mortgage during a normal year, may fall close to the danger line when there is a substantial drop in gross revenue. A single large bond issue, therefore, is better than a number of small issues. Wisely financed companies usually finance expansion during periods of prosperity through the sale of stock or debenture bonds, saving for bad times securities that have a first claim on earnings, and in furtherance of the principle refunding bond issues into stock as soon as the opportunity arises.”¹

Bases of Capitalization.

A corporation may be capitalized on any one of three bases with respect to the relationship between asset value and amount of securities issued. These bases are:

1. On earning capacity.
2. At real value.
3. Below real value.

Earning capacity.—This method is used frequently when a corporation is formed to take over other going concerns. Let us suppose, for example, that a going concern is to be taken over which has a legitimate capitalization of \$300,000 representing its true property

¹ Crow, “Corporation Secretary’s Guide,” (Prentice-Hall, Inc., New York), pages 424, 425.

value, while its net earnings have been \$100,000. The \$100,000 earning capacity is a 10% return on \$1,000,000 and the new company will issue this amount of capital in taking over the old concern.

In answer to the question as to the advantage of earning a 10% dividend on 10,000 shares instead of a 33 1-3% dividend on 3,000 shares, it may be replied that if stock with par value \$100 were to receive a 33 1-3% dividend its market value would be much higher than its par value.

Experience has shown that shares selling far above par value have the psychological effect of reducing their marketability, and command a lower market price in proportion to their yield than do stocks selling at or near par. Stocks issued with \$100 par value but earning a 33 1-3% return would approach a market value of three times their par value. Purchasers might hesitate about purchasing a share marked \$100 for \$300, despite its earning power and consequent actual value. The gap between market value and par value may, therefore, be reduced by increasing the capitalization or number of shares outstanding, thus distributing the same earnings over the larger number of shares at a lower rate.

If the case just treated were a public utility, its rates being governed by a public service commission, a small dividend on a large capitalization would appear less profitable than a large rate of return on a small one. For this reason public utilities have frequently adopted this base of capitalization.

This practice may lead to excessive capitalization or "watered stock" when earning capacity is over-estimated, but it is quite a legitimate practice when properly used. The following simple balance sheet will illustrate capitalization at earning capacity:

<i>Assets</i>		<i>Liabilities, etc.</i>	
Property value	\$300,000	Preferred stock	\$300,000
Good will	700,000	Common stock	700,000
	<hr/>		<hr/>
	\$1,000,000		\$1,000,000

Capitalization at real value.—If the newly created corporation is organized by a small group, the stock and

bonds to be closely held by the group, each individual will subscribe for the exact amount of stock representing his investment. Thus, if five individuals desire to incorporate on this basis, taking equal amounts of stock of par value \$100, and the capitalization is to be \$500,000, each will have 1,000 shares offsetting an investment of \$100,000 each. The balance sheet, assuming each paid cash, would stand:

<i>Assets</i>		<i>Liabilities, etc.</i>	
Cash	\$500,000	Capital stock	\$500,000
	<hr/> \$500,000		<hr/> \$500,000

Capitalization at less than real value.—This form of capitalization is usually employed, as in the case just considered, by small close corporations. Assume a partnership consisting of three members which is about to incorporate. Their property, or assets, have a legitimate value of \$500,000. A may take 10 shares of par value \$100. B and C will take the same amounts. The original balance sheet will then stand:

<i>Assets</i>		<i>Liabilities, etc.</i>	
Property	\$500,000	Stock	\$ 3,000
	<hr/> \$500,000	Surplus	497,000
			<hr/> \$500,000

In this case the term *surplus* is a “padding” account, and is not available for dividends. There are two main advantages in this method. (1) It reduces to a minimum organization fees and other government charges based on capital stock issues. (2) Such a capitalization attracts little attention from competitors. In case of high profits it is obvious that the rate of dividend on a small stock issue would be comparatively large and might attract attention. To avoid such a situation profits are frequently distributed as salaries and the surplus available for dividends reduced. In the case being considered, earnings of \$3,000 if distributed on the 30 shares of \$3,000 capitalization would necessitate a 100 per cent dividend. The rate would be reduced to 0 per cent if each were to receive a \$1,000 extra salary, charged to expense.

Marketing securities.—After the organizers have determined upon the relative proportion of stock and bonds to use in securing capital and on what bases the capitalization is to rest, there remains the problem of exchanging the securities for cash or property.

In small enterprises the organizers usually take large portions of the stock, at least enough to maintain voting control. The remaining shares may be sold to those closely connected with the organizers or direct to the general public.

In the larger enterprises the stock may be sold direct to the public but it is frequently placed in the hands of brokers or banking houses who sell the stock on a commission basis or buy outright for resale. These methods received complete treatment in the chapter on promotion.

Problems.

1. You are in partnership with X and Y. You decide to incorporate. Your property is valued at \$300,000 and annual net earnings have been \$30,000. Draw up simple corporate balance sheets to show how you might capitalize:

- a. At real value.
- b. On earning capacity.
- c. At less than real value.

2. Explain the motives in using each method of capitalization suggested in problem 1.

3. The preferred stocks in your company are preferred as to 6 per cent dividends. If nothing else concerning them is stated in the charter what are their rights compared with common as to:

- a. Voting power?
- b. Cumulative dividends?
- c. Sharing in profits over 6 per cent on the total capitalization?
- d. Sharing assets upon liquidation?

CHAPTER IX

THE CHARTER: CORPORATE LOCATION AND DURATION

Regardless of where the major portion of the business of any enterprise is to be transacted it may be desirable to incorporate in a state, or in different states, for the purpose of securing to the corporation certain advantages which the general incorporation laws of that state or those states may offer. For, in addition to possessing most of the attributes of a human being, the corporation has the quality of being able to determine whom its parents shall be and, usually, of fixing the length of its own life. Thus, although the state is the creator of the corporate form, the creature may function in any state or states, while securing its charter grant in another. This extension of reciprocity simplifies the interstate relationships among corporations but likewise, as will be discovered later, gives rise to considerable complication among states.

Foreign and Domestic Corporations.

As a starting point it may be said that a safe rule to follow in the matter of choosing a state in which to locate is to select the state in which the principal business is to be transacted. In such case the corporation is said to be "domestic." Frequently, however, it is preferable to secure a charter in one state even though the majority of business will be done elsewhere. In this case the enterprise is said to be "foreign" with respect to the state in which business is done. For example, the United States Steel Corporation is chartered in New Jersey, although comparatively little of its business is done in

that state. It is, therefore, a domestic corporation with respect to New Jersey, but a foreign corporation elsewhere. The present chapter is concerned with an analysis of the relative merits of the foreign and domestic incorporations.

Choice of Location.

In selecting a state in which to incorporate the following factors are considered:

1. Reputation of state.
2. Organization costs.
3. Liability of stockholders.
4. Franchise taxes.
5. Inheritance tax.
6. Stamp transfer tax.
7. Reports.
8. Condition of corporate laws.
9. Duration permitted.

Reputation of state.—Some states are less rigid in their requirements for incorporation than others. Thus New Jersey, Delaware and Arizona, while harboring some of the best of the country's enterprises have also attracted some of lesser merit due to greater laxity in their requirements. It follows, therefore, that if there be any danger in reputation, such states are to be avoided. It is doubtful if this danger ever manifests itself to any alarming degree.

Organization costs.—It will be remembered that, when the charter was sent to the secretary of state for filing, it was necessary to accompany it with a certified check for \$20 as a filing fee. In addition all incorporating states exact an organization fee, the amount varying materially in different states, but always based upon the amount of capital stock issued. In New York the fee rate is 50 cents per \$1,000 when stock has par value, or 5 cents per share for stock having no par value. The table at the end of Chapter VI shows the rates of organization fee for four of the leading incorporating states. It may be noted that if the charter of a corporation called

for an authorized stock issue of \$10,000,000 the amount of the fee would be \$600 in Delaware, \$2,000 in New Jersey, \$5,000 in New York and \$20,000 in Pennsylvania. It is easily seen why, by incorporation in New Jersey instead of Pennsylvania, the United States Steel Corporation saved over three and one-half million dollars in incorporation fees. However, unless there is a material advantage in saving of fees, the rule as to where to incorporate should still be followed.

Liability of stockholders.—It will be remembered that in the partnership form, each partner is individually liable for the debts incurred by any or all of the remaining partners. It should also be recalled that in the corporate form, the corporation is a legal entity and, as such, has to pay its own debts. Therefore, once the stockholder has paid in full for his stock he can be held for no debts of the corporation. In some states there is an exception to this rule in that the stockholders are liable for unpaid wages to workers in proportion to stockholdings, and in some cases are liable for corporate debts in an additional amount equal to their holdings. These cases are rare, however, and are of little importance.

Franchise taxes.—For the right of doing business with the consent of the state and of doing things granted by the corporate charter, the corporation is required to pay to the state granting the right an annual franchise tax varying in different states. In New York state it takes the form of a $4\frac{1}{2}\%$ state income tax. In other states, such as New Jersey and Delaware, it takes the form of a rate charged upon the authorized capital stock, as in the case of the organization fee. It may be observed that for a \$10,000,000 authorization of capital stock in the certificate of incorporation the annual franchise fee in Delaware is \$275 while in New Jersey it would be \$4,250. In a few states, notably Massachusetts and New York, the franchise tax takes the form of a state income tax, and cannot be compared with that of Delaware and New Jersey.

Inheritance taxes.—Without going at length into the theory underlying inheritance taxes, or the method of

its application, reference should here be made to the relative policies of the various incorporating states in the matter of such taxes. It is not so much a question of whether or not the tax exists in this or that state, for nearly all states have enacted inheritance tax laws, but rather a problem of determining where the tax is least burdensome.

By way of explanation it may be said that upon the death of the owner of corporate stock, the corporation is prohibited from transferring the stock on the records of the corporation until after submitting proof that state inheritance taxes have been paid when the stock passes from the estate of the decedent to his heirs. These taxes are to be paid, in many cases, in both the state of residence of the decedent and in the incorporating state. In New York, for example, the law has provided that unless a foreign corporation held real property within the state, its stock is not taxable under the inheritance tax law. It has been possible, however, for stock belonging to the estate of a decedent who had been residing in Pennsylvania, holding stock in a corporation incorporated in New Jersey and holding real estate in New York, to be taxed three times under the inheritance tax laws of these three states. These taxes have been known to consume as high as 52 per cent of the face value of the stock after the state of residence of the decedent, the incorporating states and all states in which the corporation had property had collected inheritance taxes. A number of states, New Jersey for example, have cleared up this duplication of taxation by amending the tax laws, exempting from the tax the shares owned by non-resident decedents. Delaware has always made the above exemption.

Transfer taxes.—Some few states have followed the lead of the federal government in charging a tax on transfers of shares of ownership. Unlike the federal government, however, no tax is placed against the original issue of stock, but only against subsequent transfer from owner to owner. In all states having transfer taxes the rate is 2 cents per share of \$100 par value or fraction thereof,

or 2 cents per share for shares without par value, the tax to be paid by the seller.

Methods of Avoiding Fees and Taxes.

It is a relatively simple proposition to incorporate within a state having low organization fees and franchise taxes. But it is frequently possible, when foreign incorporation is undesirable, to adjust the incorporating procedure so as to make fees and taxes less burdensome within the state where the principal business is to be transacted. One method employed is capitalization at less than real value of the assets or issuing bonds instead of stock in order to reduce the amount of capital stock against which the state may levy fees and taxes. Small close corporations might employ such devices to advantage.

Another possibility of avoidance lies in the employment of double incorporation. Under this method a company is incorporated in a state having lower fees and taxes than the state in which the principal business is to be transacted. A large stock issue comes out of this organization procedure, by which the major portion of the capital is secured for the purpose of financing the operations of a producing company incorporated in the state of high fees and taxes with a capitalization amounting to only a mere fraction of what would have otherwise been necessary, thus reducing these costs. Frequently, in the past, corporate income taxes have been avoided by the action of the directors in appropriating larger portions of the income for advertising, salaries, and other expenses, thus reducing the taxable portions. The evil of salary extension as a means of evasion has been somewhat obviated by limitations on the increase in salaries by the federal and state tax laws. For example, the federal requirement is that sums paid ostensibly as salaries, but actually as distribution of profits, to escape the application of the income tax, cannot be deducted as exempt from taxation, the *reasonableness* of the amount in question being the determining factor. If the amount

is paid in proportion to the amount of stock held by the recipients, it is treated as a payment of a dividend on such stock. Ordinarily, the legitimate payment of salaries to officers and employees, including bonuses, Christmas gifts, and the like items, are deductible and exempt from the application of the income tax.

In the larger corporations where stock is widely held it is not always possible to increase salaries owing to salary limitations placed in the charter to protect the dividend interests of the stockholders. The nature of these limitations will be considered in detail in a future chapter.

Corporate Reports.

In addition to tax reports which are a part of the corporate tax systems, many state governments require a number of reports setting forth the personnel and activities of particular enterprises. These reports may be listed as:

1. Annual reports of domestic corporations.
2. Annual reports of foreign corporations.

In New Jersey, for example, the law provides that both domestic and foreign corporations must file, within thirty days subsequent to the first election of directors and officers and annually thereafter, a report authenticated by signature of either the president and another officer or by any two directors of the corporation.

This report sets forth:

1. Name.
2. Location of registered office in the state and the name of the agent on whom process against the corporation may be served when necessary.
3. Nature of the business.
4. Amount of authorized capital stock and amount issued and outstanding.
5. Names and addresses of all directors and officers with date of expiration of terms of each.
6. Date of next annual meeting.

7. Whether the name of such corporation has been at all times displayed at the entrance of its principal office in this state, and whether such corporation has kept at this registered office in this state a transfer book in which stock transfers are recorded, and a stock book.

Qualifying as a foreign corporation.—In case a corporation contemplates obtaining its charter in one state with the idea of doing business wholly in another, or even incorporating in a state wherein its principal business is to be transacted while engaging in a large or small way in business in foreign states, it is essential that such a corporation qualify as a foreign corporation in states other than the one granting the charter. The qualification requirements demand that a foreign corporation doing business within a state register or secure a license to do business in that state and in some cases the payment of an initial fee, or an annual license tax. New Jersey requires the foreign corporation doing business within its boundaries to file a copy of its charter secured in the state of domesticity, a statement of the amount of authorized capital stock and the amount issued, the character of the business to be transacted and designating a principal office in charge of an agent, either a corporation domestic in New Jersey, or a natural person, upon whom process may be served if necessary. Upon compliance with these requirements the foreign enterprise receives a certificate from the state authorizing it to do business on a par with domestic corporations.

The fee for filing of the charter with the secretary of state is \$10 unless the home state of the qualifying corporation charges New Jersey corporations more, in which case the corporation must pay an amount equal to what its home state would charge a New Jersey corporation.

Effects of failure to qualify.—Three types of penalties attach to failure to qualify as a foreign corporation.

1. A fine payable to the state.
2. Refusal of courts in foreign states to enforce contracts.
3. Liability of officers and directors as partners.

A number of states have enacted statutes exacting fines against unqualified foreign corporations ranging from \$100 to \$5,000. These penalties have been fought by offenders, but have been sustained by the United States Supreme Court.

More commonly, the corporation failing to qualify finds itself unable to enforce its contracts where the other parties with whom it has transacted business in the foreign state are sufficiently well informed to take advantage of the law. For example, some years ago, a Wisconsin corporation lost a suit to collect a debt amounting to \$32,224 for installing an automatic fire sprinkler in a building in Detroit, Michigan, in which state it had failed to qualify as a foreign corporation.

Likewise, the officers and directors of a corporation not qualifying in a foreign state may find themselves liable in case of default on debts contracted by their corporation, much as they would in case their relationship to the business were that of partners. To illustrate, the directors and officers of a Maine corporation, doing business in the State of Illinois, but which had failed to qualify as a foreign corporation, were held liable on an advertising contract amounting to \$15,710.25 which their corporation was not able to pay. These instances emphasize the necessity for the qualification procedure where they are engaging in business in foreign states.

When are foreign corporations "doing business"?—So far we have proceeded on the basis that the qualification for foreign incorporation is a simple matter. But brief analysis of an additional phase of the problem will show that such is not the case. The regulation of interstate commerce is reserved by the federal constitution for federal jurisdiction, so that business actually done within a state, that is, *intrastate* business, and business done among states, that is, *interstate* business, must be distinguished where states attempt to assume regulatory jurisdiction. For example, a mail order house dealing directly with consumers in each state in the Union need not qualify as a foreign corporation in each of forty-eight states in as much as its business is distinctly *inter-*

state. But many cases are less clearly defined, as may be shown by making the following inquiries:

1. Does a single transaction in a foreign state constitute doing business there, requiring qualification as a foreign corporation?
2. Does selling goods in outside states through traveling salesmen constitute "doing business"?
3. Does maintaining an office in a foreign state constitute "doing business" there?
4. Are sales "on consignment" doing business?
5. Does storage of goods in warehouses in foreign states constitute "doing business" there?
6. Is construction work in foreign states "doing business"?

Other problems may contribute to the complexity already suggested, but sufficient questions have been asked to indicate the difficulty involved. Any student familiar with corporation law will agree that the answers to the above queries must, at best, be made with considerable generality, as there is little uniformity of statute provision or court interpretation as among states.

In answering the first question it may be stated that an examination discloses the fact that an isolated transaction in a foreign state does not create the foreign corporation relationship requiring qualification as such, the interpretation being that the real test is as to whether or not the intent is to *engage* in business within the state. A few cases of opposite interpretation might be cited.

Even greater uniformity of opinion seems to exist where goods are sold through traveling salesmen or drummers, excepting where the goods are later delivered personally by the salesman, in which case the transaction may constitute doing business within a state.

No inclusive statement can be made as to whether or not maintaining an office in a state constitutes "doing business," thereby requiring the corporation to qualify as a foreign corporation. It is probable, however, that such an office would be *prima facie* evidence that the company is doing business, and it is probably better to

consider this as the true situation. However, when transactions are strictly interstate in character; or are mere purchases through the office for delivery outside the state; or the office is used only for display of samples, qualification as a foreign corporation has been held not to be necessary in a number of cases.

Opinion seems to hold that sales on consignment do not constitute "doing business" as a foreign corporation. By consignment is meant the sending of goods to be sold by a consignee for the consignor, title remaining in the seller or consignor, the consignee accounting to the consignor for the proceeds of sale.

The opposite conclusion can probably be reached as to storage of goods in warehouses, especially if the goods are to be distributed under contracts calling for retail sale within the state, title remaining with the selling corporation until the full contract price is received. Frequently, opposite holdings might be found, but always the merits of individual cases are considered.

As to construction work, where a corporation holding a charter in one state is engaged in the erection of buildings or other structures in another state, the question immediately arises as to the necessity of qualifying as a corporation in the foreign state for this particular engagement. Here again the answer is necessarily indefinite, as cases in the courts have held both ways. It may be suggested, however, that wisdom dictates that, before the contract for construction is signed, the corporation examine the situation, on the assumption that qualification will be necessary.

Foreign corporation taxes.—Incorporation in states having low fees and annual taxes has been suggested as being one method commonly employed to reduce the burden incident to organizing under this form. In case the incorporators secure a charter in Delaware, where the initial organization fees and the annual franchise taxes are relatively low, but carry on their business as a foreign corporation in New York, they will be compelled to pay additional fees and taxes in New York. The taxes, as in most states, take the nature of a franchise tax, usu-

ally based on the amount of capital stock authorized or issued, or the amount represented by the value of the property employed in the foreign state. In New York it takes the form of the $4\frac{1}{2}\%$ income tax applied to domestic corporations. It may be shown then that where the double cost of fees or taxes in both domestic and foreign states equals or exceeds that incident to incorporating within the state where the main portion of the business is to be transacted, there is little to be gained by foreign incorporation, and that it may even be more advantageous and economical to organize a subsidiary company in the desired state with a small capitalization, than to attempt to incorporate in one state with the idea of qualifying elsewhere as a foreign corporation.

Condition of corporation laws.—In choosing a state in which to incorporate, the stability of the laws and the construction placed upon them by the courts are important items to be considered. In Delaware, for example, one might expect to find little difficulty arising out of frequent changes in legal requirements since, in the past, the laws have rarely been amended. The same may be said of the states of Maryland and Arizona. In New York the law has been frequently amended. Illinois and New Jersey represent states in which occasional amendment has taken place in the past.

In the older and more important incorporating states such as Delaware, Maryland, New Jersey and New York, the courts, both federal and state, have thoroughly construed the state laws so that little doubt exists as to what interpretation will be placed upon the incorporation laws.

In states where new laws have recently been passed, as in Florida, or in such states as Nevada and Arizona, where relatively few corporations exist, little construction has been placed upon the laws by any courts. These possibilities are worth consideration when it is remembered that charter and by-law provisions may need altering when state laws are changed or new court decisions interpret or reinterpret a law.

Duration.—Most of the important incorporating states permit the charter to provide for permanent existence.

Originally the idea seems to have prevailed that short renewable terms of corporate life provided a better check on corporate activity. However, the fact that the state reserves the right to dissolve the organization with just cause forms a sufficiently constant and adequate check.

The advantage of permanent duration lies in the improvement of general stability of business conditions.

Where the charter provision limits the duration of the corporation to a period of years, the stipulation may be made that the enterprise may have its life renewed for an additional period. When the charter provision designates perpetuity there are still a number of factors which may contribute to the breaking up of the enterprise. This dissolution may be *voluntary*, where the stockholders vote to dissolve, or *involuntary*, when bankruptcy, insolvency, court decree resulting from illegal practices, or failure to comply with the state regulations incident to the charter grant bring about forfeiture of the charter. Sometimes, in cases of insolvency, the creditors arrange to have the corporate affairs placed in the hands of designated agents under whose management the financial conditions may be brought back to a profitable basis, justifying their return to the management of the directors. This reorganization policy may be pursued in cases where the good-will of the creditors toward the embarrassed enterprise is sufficiently urgent, or where the interests of the creditors are better protected than they would be under complete dissolution.

Corporate activity may also be discontinued without formal dissolution if elimination of publicity is desirable, by the execution of a certificate of discontinuance of business, to be filed with the state and federal tax authorities who mark their tax records accordingly. This procedure may be considered dangerous and unwise in view of the possible subsequent liability to parties ignorant of discontinued activity on the part of the corporation.

The detailed analysis of dissolution and reorganization leads too far into the fields of law and finance and consequently is without the scope of this discussion.

Problems.

1. You are organizing a corporation to manufacture artificial honeycombs. What factors would enter into your choice of a state in which to apply for your charter?
2. In case you choose to be a "foreign corporation," how would you qualify as such?
3. What is the effect of failure to qualify?
4. What efforts might be made to avoid burdensome taxes?

CHAPTER X

THE CORPORATE CHARTER: STOCKHOLDERS AND DIRECTORS; CHARTER AMENDMENT

The charter may say little or much concerning the directors or stockholders, but usually little is said concerning officers. In general these three groups secure their "working orders" largely from the by-laws, being limited in many respects by both statute and common law. It seems proper here to consider the general nature of the stockholding and directing groups, together with their liabilities, reserving the detailed analysis of their functioning to the chapter on the by-law provisions concerning them.

The Stockholders.

When the investor exchanges his money for stock of the corporation, either when issued direct from the company or when purchased on the general market, or stock market, he becomes a stockholder. He is the owner of the enterprise although, as has already been discovered, he delegates or surrenders to the directors elected by him the actual conduct of the business, and retains almost no control for himself. A charter containing the minimum provisions merely mentions the names and addresses of the stockholders and the amount of stock subscribed for by the original incorporators. It may be well, therefore, to inquire into the nature and function of the stockholding group at this point. This inquiry centers about:

1. The individual rights of stockholders.
2. The group powers of stockholders.
3. The liability of stockholders.

Individual rights.—As has been said, the stockholders retain little control over the management of their own enterprise. As individuals they are entitled to vote either in person or by proxy at all meetings held by stockholders to elect directors, and carry on such other activity as is reserved to them. Each share usually carries one vote.¹ The nature of these meetings will be discussed more fully in connection with the study of the by-laws. It may be added that some states, as in New York, have statutory provisions giving the stockholder a second right, that of receiving notice of regular and special meetings of the stockholders.

In the discussion of corporate stock it was pointed out that each share of stock is entitled to its proportionate share of any profits distributed. This constitutes another right of the stockholder. Likewise, he may share proportionately in the distribution of remaining assets after corporate debts are settled upon liquidation. These items have already been considered in connection with the analysis of the stock system.

Formerly, under the common law, the stockholder had the additional right to inspect the corporate books. In some states this right has been abridged by statute law on account of the fact that unlimited inspection becomes burdensome to corporate officials in charge of the records, and supplies opportunity for corrupt practices since, by buying one share of stock on the market, competitors would have access to information to which they have no legitimate right. Where this abridgment exists it is necessary for the party desiring to inspect the books to secure a court order to do so, after stating the purpose in asking for the privilege of inspection. One of the largest Delaware corporations provides in its charter that the directors shall have the right "from time to time to determine whether and to what extent, and at what time and places and under what conditions and regulations the accounts and books of the corporation (other

¹ A recent study under direction of the author showed that an average of 75% of possible votes are cast in meetings, 73% being by proxy and 2% in person.

than the stock ledger), or any of them, shall be open to the inspection of the stockholders; and no stockholder shall have any right to inspect any account or book or document of the corporation, except as conferred by statute or authorized by the Board of Directors or by a resolution of the stockholders." The following newspaper report will illustrate:

"Right to inspect the stock book of the Boise Homesite Company, Inc., was granted to Mr. and Mrs. George Taylor, 611 West Genesee Street, by a decision handed down by Justice Edgcomb yesterday afternoon. The couple are stockholders and made an application for an order of mandamus under section 10 of the stock corporations law.

"Charles J. Boise, president of the corporation, fought the move to open up the books to Mr. and Mrs. Taylor. He filed affidavits that claimed a former salesman for the Homesite company was a roomer in the Taylor home at one time and is now in the employ of Van Dyke Builders, Inc., a competitor. Francis Van Dyke was formerly sales manager of the Boise Homesite corporation and is now a member of Van Dyke Builders, Inc.

"Justice Edgcomb ruled that Mr. and Mrs. Taylor might inspect the Boise corporation books on April 4 for a period of not more than three hours and might make notes from the book that contained the list of stockholders, their addresses and the shares they own.

"The court ruled the law is clear and he was without power to block the inspection even if there might be an ulterior motive, as Boise claimed in his battle against the mandamus.

"The application is opposed upon the ground that the information was not sought for any legitimate purpose but rather for some ulterior design which would work to the detriment and annoyance of the Boise corporation," Justice Edgcomb said in the memorandum.

"The affidavits presented by the corporation tend to support such a claim and lead one to suspect the motives

of the petitioners. If this were addressed to my discretion, I should be inclined to deny the motion.

“‘As I view the law, however, the petitioners are entitled to the order they ask as a matter of right, and the court is not vested with any discretion. The motives of the applicants are no concern of the court.’

“Justice Edgcomb found that Mr. and Mrs. Taylor had owned stock in the Boise corporation for upwards of six months prior to March 8, the day the demand for an inspection was refused by Boise. The law quoted by the court states that any stockholder for a period of six months is entitled to access to the stock book of a corporation, which is required to keep stockholders listed in alphabetical order with addresses and notations as to their holdings.”

Where not conflicting with the statutes, additional rights may be granted in the charter such as cumulative voting, to be discussed later, and other protective measures for the minority group of stockholders.

Group powers.—Assembled in their meetings the stockholders usually have power to:

1. Elect directors.
2. Amend the charter with the consent of the state office granting it.
3. Sell the assets.
4. Adopt or modify by-laws in some way.
5. Dissolve the corporation; or other items over which the charter may give control.

Liability of stockholders.—One of the chief advantages of the corporate form has been designated as “limited liability” as distinguished from the “unlimited liability” of partners in a partnership. As a legal entity the corporation pays its own debts without reference to its members. Once the stock has been fully paid for, further liability ceases. Until such payment has been made the stockholder is liable for the unpaid balance, in case a creditor has been unable to collect from the corporation.

An innocent purchaser of stock not fully paid for is

not held for additional payments, such liability resting with the seller.

As mentioned in another connection, some states make full paid stock liable for unpaid wages to workers and in some cases apply the double liability of banks to industrial and commercial corporations.

Liability is a question of common and statute law and can be regulated in no way by charter provision.

Directorships.

The directors, acting as a group, constitute the agents of the corporation and hold the sole power to make contracts. The powers of the directors are, of course, limited to the prosecution of the purpose specified or implied in the charter. Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient. The directors could not, however, indulge in any radical change, such as selling the entire assets, or dissolving the corporation, without the consent of the stockholders. Limitations are frequently placed upon the actions of the stockholders by charter or by-laws which regulate the directors in the general conduct of the business.

Sections 7 and 8 of the certificate of incorporation reproduced in Chapter VI contain the provisions concerning the directors of the corporation. It has already been suggested that one of the chief advantages of the corporate form is the delegation of authority for running the affairs of the enterprise to a central control mechanism, a board of directors. Little is said in the charter concerning the functioning of this board, the names and addresses only being included. The details of their functioning are set out more fully in the by-laws which are

to be analyzed in a subsequent chapter. In some states the directors are not appointed or elected until after the certificate of incorporation has been granted and the incorporators have held their first meeting, at which time the directors are elected. In these states the names of the directors to be chosen need not be included in the charter.

In most states, the statutes require a minimum number of directors, but not, usually, a maximum. Obviously the functioning and purpose of directorships would be defeated if the group should grow to large proportions, since they would tend to become unwieldy. Directorship groups in industrial and commercial enterprises run from three as a minimum up to twenty-seven or more in large corporations. The advantage in larger directing groups lies in the more varied qualities represented. Bankers, financiers, successful business men, lawyers, etc., may be represented on a board when it assumes larger proportions.

Directors are elected annually by the stockholders to formulate policies as to the conduct of the enterprise. They do not devote their whole time to directing the enterprise, but meet from time to time to determine policies and to choose officers to execute these policies. As directors they usually receive no salary, but are paid a fee for attending meetings and expenses of traveling.

The Liabilities of the Directors.

Both the common and statute law define the liabilities of directors to the state, the stockholders, and third parties. These liabilities are placed upon the directors to protect creditors and stockholders in a general way against illegal, *ultra vires*, or negligent practices. A simple list of possible offenses will serve to suggest specific acts for which the directors may legally be held liable:

1. *Ultra vires* acts.
2. Illegal corporate acts done with their connivance, knowledge or consent.

3. Issuing unpaid or part-paid stock and marking it full paid.

4. Dividend payments declared either negligently or purposely, impairing the capital stock.

5. General gross mismanagement.

6. Loaning corporate funds to stockholders or discounting their notes out of corporate moneys.

7. Making false notices or reports that deceive the public.

8. Transferring property to officers or stockholders to defraud creditors at times when insolvency becomes possible.

9. Suffering any loss to creditors or stockholders as trustees in case of dissolution.

Quite frequently it is possible to find in various state incorporation laws additional acts for which the directors of corporations may be held liable. In general, however, the above list gives a fair representation of what one might expect to find in most states.

Special Charter Provisions.

It will be noticed that the regulation of rights, powers and liabilities of directors which has been considered thus far lies in statutory and common law provisions. It is possible, however, for the corporation to control the activities of the directors through special charter provisions so long as they do not violate the provisions specified by law. These special charter provisions have to do with the protection of the stockholders, especially of minority groups. The following list is suggestive, and further possibilities will be considered in the chapter on protection of special groups:

1. Limitations on directors:

a. Indebtedness;

b. Salaries;

2. Voting provisions:

a. Cumulative voting;

b. Stock classification.

Limitations on Directors.

It may be unwise to place any limitation on the amount of indebtedness which may be incurred by the corporation. Presumably the directors are chosen because of their proven ability and sagacity and, left alone, will conduct the corporation successfully and profitably. However, if we assume that the large majority of enterprises fall by the wayside after brief existence, and this is a safe assumption, we must inquire into the cause of this tremendous fatality. It will be found that abuse of borrowing power or mistaken estimates as to the probability of success of an enterprise contribute largely to the casualties; hence the debt limitation.

These restrictions should not be too rigid, however, for a certain varying amount of indebtedness is inevitable. Thus an absolute limit, sometimes employed, is not sufficiently elastic. Other possibilities are:

1. Limits based on a percentage of capital stock issued.
2. Personal liability of directors for debts incurred beyond a certain sum.
3. Consent of the stockholders for debts incurred over a certain amount.

This list of limitations needs no explanation.

Salaries.—Stockholders may likewise be injured by a diversion of profits into excessive salary payments to officers by the directors. For the protection of the owners it is, therefore, frequently wise to create in the charter or by-laws some salary limitations. The provision may be similar to the ones limiting debts, and similarly, should be sufficiently flexible to permit of variation and extension of reward to executive ability and genius. Following are listed the principal devices used in the limitation of salaries:

1. Salaries increased only with large majority or entire vote of the board of directors.
2. Salaries fixed by the stockholders in the annual meeting.

3. Salary increases dependent on the previous size and regularity of dividends distributed to stockholders.

If these provisions are likely to be varied from time to time they should be included in the by-laws instead of in the charter, in order to permit of change without amending the charter, which is difficult of accomplishment as will be discovered later.

Special Voting Provisions.

Ordinarily each share of voting stock is entitled to one vote. It is sometimes possible, however, to deviate from the common practice in order to accomplish some particular purpose which is usually concerned with the protection of certain groups. Analysis of two of the commonest plans, cumulative voting and classification of stock, will serve to illustrate this point.

Cumulative voting.—Cumulative voting may be, according to statutory provisions, either permissive or mandatory. For example, the New York law specifies that the certificate of incorporation may provide that at all elections of directors each stockholder shall be entitled to as many votes as shall equal the number of his shares of stock multiplied by the number of directors to be elected, and that he may cast all of such votes for a single director or may distribute them among the number to be voted for as he sees fit. The Pennsylvania law specifies that, in all elections for directors each shareholder may cast the whole number of his votes for one candidate or distribute them as he sees fit, whether or not the charter provides for cumulative voting.

Stock classification.—Sometimes, in order to prevent so great a concentration of control in small groups, the charter provides for granting the usual vote per share up to a certain number of shares, any additional shares having reduced voting power. For example, the first 100 shares might have 100 votes and the second 100 shares might be reduced to 50 or one-half vote per share instead of one full vote.

Another method of classification of stock may be illus-

trated by reference to the charter of the National Cash Register Company which provides that "the holders of Common B Stock, at any meeting for the election of a Board of Directors, if a majority of the outstanding shares of such stock shall be represented at such meeting, shall be entitled, to the exclusion of the holders of the Common A Stock, to elect a majority of the members of the Board of Directors and at any meeting for the election of directors the holders of Common A Stock shall be entitled, to the exclusion of the holders of Common B Stock, to elect members of the Board of Directors sufficient in number, together with the directors, if any, elected as aforesaid at such meeting by the holders of Common B Stock, to complete the entire Board of Directors."

Charter Amendment.

Frequently it becomes necessary or desirable to modify charter provisions due to omission at the time of granting or the growth and expansion of an enterprise or to other cause. Charter amendment is, at best, burdensome, varying all the way from securing court sanction to a simpler procedure similar to obtaining the original certificate.

New York State requires that the desired amendment be passed upon favorably by at least a two-thirds majority vote of the stock outstanding, in a duly assembled meeting. Other states vary the requirements as to the majority and in some cases require that the amendment be advertised for a specific length of time before going into effect. This provision protects both stockholders and outside parties. Following is such an advertisement concerning a charter amendment in an Ohio corporation:

Notice.

To whom it may concern:

Notice is hereby given that on Saturday, the 2nd day of June, 1923, at a meeting of the stockholders of the Columbus Pharmaceutical Company, held at the office of the company it was by a vote of more than three-fifths of the common stockholders

Resolved, that the articles of incorporation of the Columbus

Pharmaceutical Company be, and the same hereby are, amended so that Article IV of said articles of incorporation shall read as follows:

ARTICLE IV.

The capital stock of the corporation shall be two hundred thousand dollars (\$200,000) divided into four thousand (4,000) shares of fifty dollars (\$50.00) each.

No stockholder shall sell or otherwise dispose of the whole or any part of his stock unless he shall, at least ten (10) days previous thereto have offered in writing to sell the same to the board of directors upon the same terms and for the same price as he shall have been offered by his prospective purchasers, and such offer to said directors shall not have been accepted within that period.

A. M. CUTLER,
Secretary.

Generally, the amendment goes through the same channels as did the original certificate after receiving the approval and sanction of the required number of voting shares, certain fees being required as in case of the original application.

Problems.

1. Complete the following chart:

CLASSIFICATION	INDIVIDUAL RIGHTS	GROUP POWERS	LIABILITIES
Stockholders			
Directors			

2. The rights, powers, and liabilities listed in the above chart are determined by state laws and custom. What is the

nature of special charter provisions which may supplement these legal specifications? Explain.

3. You wish to amend the charter of the Artificial Honeycomb Corporation in order to change its capitalization. Explain the procedure.

CHAPTER XI

THE BY-LAWS: PROVISIONS AS TO STOCK-HOLDERS

Such minute details of corporate control as are not required by law to appear in the charter and which may vary over short periods of time are, for the most part, included in a supplementary document, the by-laws. In addition, some important regulations found in the charter or statutes may be re-stated in some way in the by-laws for the purpose of emphasis. As in the case of the certificate of incorporation or charter, the by-law provisions are subject to legal requirements and, in addition, are subservient to the certificate. It is frequently said that the corporate charter may be compared with the constitution of a state and the by-laws with statute law.

How By-Laws Are Made.

Section 11 of the General Corporation law of New York states that every corporation has the right, though not specified in the law, "to make by-laws." This statement bears out the suggestion made in Chapter VII that the making of by-laws is an implied power of a corporation, so that what is true in New York in regard to authority for making by-laws is true generally. The question now arises as to the agency through which the by-laws are drawn up; whether by the stockholders or directors. Essentially the making of the by-laws is the function of the stockholders, but in some cases, unless contrary to law, they may be drawn by the directors. It is not an uncommon practice to permit the directors to pass supplementary by-laws so long as they do not conflict with those accepted by the stockholders.

They are frequently drawn up, before the time of the first meeting of the incorporators, by the attorney for the corporation or by the attorney for the incorporating service company described previously, read at the organization meeting, and, if satisfactory, accepted and placed upon the minute books.

What Should the By-Laws Contain?

The by-laws may contain nothing which violates the provisions of the state statutes or the corporation charter. The tendency in the past has been to violate this requirement and to make the by-laws too voluminous and inclusive, to the extent that they have come to mean little in the eyes of the stockholders.

Criticism is frequently made of the manner of making by-laws and the method of their application. There can be little doubt that they are frequently made and enforced by either stockholders or directors or both, resulting in a loss of dignity and force. Certainly a move for their increased importance would not be out of order. But in any case they are essential as a set of governing rules. They are invaluable as sets of rules for control of internal relationships. Too minute regulation in either state law or corporation charter would cloud the true nature of the contractual relationship between the state and the corporation. Likewise, outsiders, such as creditors, are not concerned with detailed policies such as are regulated in a set of by-laws. Hence, their regulation finds no place in the charter. Again, internal policies are constantly changing. Changes in rules, if placed in laws or charters, which are difficult to modify, would be all but impossible. Flexibility is therefore obtained by the supplementary document, the by-laws.

From a positive standpoint it may be suggested that the by-laws should contain four classes of provisions as follows:

1. Those regulating the meetings of stockholders, directors and officers and defining or limiting their activities.

2. Those regulations permitted by the statutes if included in the by-laws.

3. Statute and charter provisions necessary to emphasize by repetition in the by-laws.

4. Regulation of stock transfer and records.

This content will become apparent upon analysis of the representative set of by-laws reproduced in the next paragraph. Some question may arise as to the wisdom of extended repetition in the by-laws of statute law. Obviously such inclusion should be accurate in its statement, and certainly frequent amendment of statute law or uncertainty as to court interpretation necessitates judicious and conservative practice in this regard, if the by-laws are to be a stable set of regulations.

The following set of by-laws will serve as a basis for further consideration:

THE WITMAN ELECTRIC COMPANY

BY-LAWS

Offices.

1. The principal business office of the corporation shall be in the City of Syracuse in the County of Onondaga, State of New York.

2. The corporation may also have offices at such other places as the Board of Directors may from time to time appoint or the business of the company may require.

Meetings of Stockholders.

3. The annual meeting of the stockholders of the corporation after the year 19—, for the election of directors and the transaction of such other business as may properly come before the meeting shall be held at the principal business office of the corporation in the State of New York, on theday of..... in each year if not a legal holiday and if a legal holiday, then on the next secular day following at.....o'clock in the..... noon.

4. Notice of the annual meeting of the stockholders shall be served either personally or by mail not less than ten nor more

than forty days previous to such meeting, upon each stockholder entitled to vote at such meeting at his address as it shall appear on the books of the corporation unless he shall have filed with the secretary of the corporation a written request that notices intended for him be mailed to some other address, in which case it shall be mailed to the address designated in such request.

5. The presence of the holders of a majority of the stock issued and outstanding entitled to vote present in person or represented by proxy is requisite and shall constitute a quorum at all meetings of the stockholders for the transaction of business except as otherwise provided by law or by the certificate of incorporation or by these by-laws. If such majority shall not be present or represented, those present in person or by proxy shall have power to adjourn the meeting, from time to time, without notice other than announcement at the meeting, until the requisite amount of stock shall be present, when any business may be transacted which might have been transacted at the meeting as originally notified.

6. The annual election of directors shall be conducted by two inspectors of election, neither of whom shall be a candidate for the office of director. The inspectors shall be chosen at each annual meeting of stockholders to serve for the ensuing year and if such inspectors shall not be present at any election, the meeting may appoint others in their place. The inspectors shall be sworn faithfully to perform their duties and shall make a written certificate of the result of the election.

7. Special meetings of the stockholders for any purpose or purposes other than those regulated by statute may be called by resolution of the board of directors or by the president, and shall be called by the president or secretary at the request in writing of a majority of the board of directors or at the request in writing by stockholders owning a majority in amount of the entire capital stock of the company issued and outstanding. Such request shall state the purpose or purposes of the proposed meeting.

8. Business transacted at all special meetings shall be confined to the object stated in the call and matters germane thereto.

9. Written notice of a special meeting of stockholders stating the time, place and object thereof shall be mailed, postage prepaid, not less than ten nor more than forty days before the meeting to each stockholder entitled to vote at such meeting

and to any stockholder who, by reason of any action proposed at such meeting, would be entitled to have his stock appraised if such action were taken. Such notice shall be directed to a stockholder at his address as it shall appear on the books of the company unless he shall have filed with the secretary of the corporation a written request that notices intended for him be mailed to some other address, in which case it shall be mailed to the address designated in such request.

Directors.

10. The affairs of this corporation shall be managed by a board of directors, whose number is fixed by the Certificate of Incorporation and at least one of whom shall be a citizen of the United States and a resident of the State of New York. They shall be elected at the annual meeting of stockholders to serve for one year and until successors shall be elected and qualify.

11. In addition to the powers by these by-laws expressly conferred upon them, the board may exercise such powers and do such lawful acts and things as are not by statute or by the certificate of incorporation or by by-laws required to be exercised by the stockholders.

Compensation of Directors.

12. Directors as such shall not receive any stated salary for their services but by resolution of the board a fixed sum and expenses of attendance, if any, may be allowed for attendance at any meeting. Nothing herein contained shall be construed to preclude any director from serving the corporation in any other capacity and receiving compensation therefor.

Meetings of the Board.

13. The directors may hold their meetings and have one or more offices and keep the books of the corporation, except such as are required by law to be kept within the State, outside of New York at the office of the corporation in the city of..... or at such other places as they may from time to time determine.

14. Regular meetings of the board may be held without notice at such time and place as shall from time to time be determined by resolution of the board.

15. Special meetings of the board may be called by the president on ten days' notice to each director either personally,

by mail or by wire; special meetings shall be called by the president or secretary in a like manner on the written request of two directors.

16. At all meetings of the board the presence of a majority shall be necessary to constitute a quorum and sufficient for the transaction of business and any act of a majority present at a meeting, at which there is a quorum, shall be the act of the board of directors, except as may be otherwise specifically provided by statute or by the certificate of incorporation or by these by-laws.

Executive Committee.

17. There may be an executive committee of directors appointed by the board who may meet at stated times or on notice to all by any of their own number, during the intervals between the meetings of the board, they shall advise with the officers of the corporation in the management of its business and exercise such powers as may be delegated by the board of directors. The board may delegate to such committee authority to exercise all the powers of the board while the board is not in session. Vacancies shall be filled by the board of directors at any regular or special meeting. The executive committee shall keep regular minutes of its proceedings and report the same to the board when required.

Officers.

18. The officers of the corporation shall be a president, vice president, secretary and treasurer, who shall hold office for one year and until their successors are chosen and qualify in their stead. Any officer elected or appointed by the board of directors may be removed at any time by the affirmative vote of a majority of the whole board of directors. Any two of the aforesaid offices, except those of president and vice president, may be filled by the same person.

19. The board of directors, immediately after each annual meeting of stockholders, shall appoint from their own number a president and vice president and shall also choose a secretary and treasurer who need not be members of the board; and a majority of the whole number of directors shall be necessary for the appointment of each of said officers.

20. The board may appoint such other officers, agents and employees as it shall deem necessary who shall have such au-

thority and shall perform such duties as from time to time shall be prescribed by the board.

21. The salaries of all officers of the corporation shall be fixed by the board of directors.

The President.

22. The president shall be the executive officer of the corporation; he shall preside at all meetings of the stockholders and directors; he shall have the management of the business of the corporation; shall see that all orders and resolutions of the board are carried into effect, subject, however, to the right of the directors to delegate any specific powers, except such as may be by statute exclusively conferred on the president, to any other officer or officers of the corporation.

Vice President.

23. The vice president, in the absence or disability of the president, may perform the duties and exercise the powers of the president, and shall perform such other duties as may be imposed upon him by the board.

The Secretary.

24. The secretary shall attend all sessions of the board and all meetings of the stockholders and act as Clerk thereof, and record all votes and the minutes of all proceedings in a book to be kept for that purpose, and shall perform like duties for any committee of the board when required. He shall cause to be given notice of all meetings of stockholders and directors and shall perform such other duties as pertain to his office. He shall keep in safe custody the seal of the corporation and when authorized by the board of directors or executive committee, affix it when required to any instrument.

The Treasurer.

25. The treasurer shall have the custody of all the corporate funds and securities and shall keep full and accurate accounts of receipts and disbursements in books belonging to the corporation and shall deposit all moneys and other valuable effects in the name and to the credit of the corporation in such depositories as may be designated by the board of directors. He shall disburse the funds of the corporation as may be ordered by the

board, taking proper vouchers for such disbursements, and shall render to the president and directors at the regular meetings of the board, or whenever they may require it, an account of all his transactions as treasurer and of the financial condition of the corporation.

26. He shall, if required by the board, give the company a bond in a sum and with one or more sureties satisfactory to the board, conditioned upon the faithful performances of his duties and for the restoration to the corporation in case of his death, resignation, retirement or removal from office of all books, papers, vouchers, money and other property of whatever kind in his possession, or under his control belonging to the corporation.

Vacancies.

27. If the office of any director or of the president, vice-president, secretary or treasurer, or other officer or agent becomes vacant for any reason, the directors in office, although less than a majority of the whole board, by a majority vote, may choose a successor who shall hold office for the unexpired term, or any such vacancies in the board of directors may be filled by the stockholders, in any meeting called for that purpose, provided due notice of the proposed election has been given.

Officers May Resign.

28. Any director or other officer may resign his office at any time, such resignation to be made in writing and to take effect from the time of its acceptance by the corporation. The acceptance of a resignation shall be required to make it effective.

Duties of Officers May Be Delegated.

29. In case of the absence of any officer of the corporation, or for any other reason that the board may deem sufficient, the board may delegate the powers or duties of such officer to any director for the time being, PROVIDED, a majority of the entire board concur therein.

Certificates of Stock.

30. The certificates of stock of the corporation shall be numbered and registered as they are issued. They shall exhibit the holder's name and the number of shares and shall be signed by the president or a vice-president and the treasurer or an

assistant treasurer or the secretary or an assistant secretary and shall bear the corporate seal.

Lost Certificate.

31. Any person claiming a certificate of stock to be lost or destroyed shall make an affidavit or affirmation of that fact and advertise the same in such manner as the board of directors may require and shall give the corporation a bond of indemnity in form and with one or more sureties satisfactory to the board, in at least double the par value of the stock represented by said certificate, whereupon a new certificate may be issued of the same tenor and for the same number of shares as the one alleged to be lost or destroyed, but always subject to the approval of the board of directors.

Transfers of Stock.

32. Transfers of stock shall be made on the books of the corporation by the person named in the certificate or by his attorney lawfully constituted and upon surrender of such certificate. Every such transfer of stock shall be entered on the stock book of the corporation which shall be kept at its principal business office in New York.

33. The transfer book, by resolution of the board of directors, may be closed for a period not exceeding forty days prior to any meeting of the stockholders or the day appointed for the payment of a dividend.

34. The corporation shall be entitled to treat the holder of record of any share or shares of stock as the holder in fact thereof and accordingly shall not be bound to recognize any equitable or other claim to or interest in such share on the part or any other person whether or not it shall have express or other notice thereof, save as expressly provided by the laws of New York.

Inspection of Books.

35. The directors shall determine from time to time whether, and if allowed, when and under what conditions and regulations the accounts and books of the corporation (except such as may be specifically by statute open to inspection) or any of them, shall be open to the inspection of the stockholders and the stockholders' rights in this respect are and shall be restricted and limited accordingly.

36. Each stockholder of record entitled to vote shall be entitled at every meeting of the corporation to cast one vote for each share of stock standing in the name of such stockholder on the books of the corporation, at any election or on any subject before any annual or special meeting of the stockholders and such votes may be cast either in person or by written proxy.

Every proxy must be executed in writing by the stockholder himself or by his duly authorized attorney. No proxy shall be valid after the expiration of eleven months from the date of its execution unless it shall have specified therein the length of time it is to continue in force, which shall be for some limited period. Every proxy shall be revocable at the pleasure of the person executing it.

Dividends.

37. The directors may declare dividends out of the profits of the corporation at such times and in such amounts as the board of directors may from time to time designate.

38. Before payment of any dividend or making any distribution of profits there may be set aside out of the net profits of the corporation such sum or sums as the directors from time to time in their absolute discretion think proper as a reserve fund to meet contingencies or for equalizing dividends or for repairing or maintaining any property of the corporation or for such other purpose as the directors shall think conducive to the interests of the corporation.

Seal.

39. The seal of the corporation shall be circular in form and contain the name of the company, the year of its organization and the words "Corporate Seal, New York."

Checks.

40. All checks or demands for money and notes of the corporation shall be signed by such officer or officers as the board of directors from time to time designate.

Waiver of Notice.

41. Any stockholder, officer or director may waive any notice required to be given under these by-laws.

42. Whenever, under the provisions of these by-laws, notice is required to be given to any director, officer or stockholder, it

shall not be construed to mean personal notice, but such notice may be given in writing by depositing the same in a post office or letter-box in a post-paid sealed wrapper, addressed to such stockholder, officer or director, at such address as appears on the books of the corporation, or in default of other address to such stockholder at the general post office in the city of....., and such notice shall be deemed to have been given at the time when the same was thus mailed.

Amendments.

43. The by-laws may be amended by a majority vote of all the stock issued and outstanding and entitled to vote at any annual or special meeting of the stockholders, provided notice of intention to amend shall have been contained in the notice of the meeting.

44. The board of directors, at any regular or at any special meeting, provided notice thereof shall have been given, by a majority vote of the whole board may amend these by-laws, PROVIDED that such amendments do not regulate or affect the election of directors or officers and are not inconsistent with the by-laws passed by the stockholders. The directors may repeal by-laws passed by them but may not repeal the by-laws passed by the stockholders.

Meetings of stockholders.—The by-laws first stipulate the location of the principal office or offices of the corporation, where the meetings of the stockholders are to be held. There are three classes of meetings in which the stockholders participate:

1. Organization meetings.
2. Regular (annual) meetings.
3. Special meetings.

1. *Organization meetings.*—The organization meeting is held immediately after the acceptance by the state of the charter application, and may be attended only by the incorporators consisting of the subscribers to the charter. Signers of subscription lists are not eligible to attend. Usually the number of incorporators signing the certificate is kept to the minimum required by the state, (three or five) and if so the assembling of the group is less diffi-

cult than otherwise would be the case. Obviously bringing order out of chaos with no officers or leaders would be difficult, especially in case of large groups. Most states require notice to be given to those eligible to participate in the meeting and with no one to issue the call or notice the problem would appear, on the surface, to be extremely difficult.

The usual method of assembling the group is through the use of a combined call and waiver of notice, prepared by any incorporator or their attorneys and signed by each signor of the charter application. Following is a sample of this document:

THE WITMAN ELECTRIC COMPANY.

CALL AND WAIVER OF NOTICE FOR FIRST MEETING OF STOCKHOLDERS.

We, the undersigned, being all of the incorporators of the above-named corporation and all of the subscribers to its capital stock entitled to notice of said meeting, do hereby call the first meeting of at on the day of, 192 , for the purpose of receiving the charter, adopting by-laws, electing directors, considering and acting upon a proposal for the issue of the capital stock of the corporation in exchange for property, and the transaction of all such other business as may be necessary or convenient in connection with the organization of said corporation; and we do hereby waive all requirements as to notice or publication of the time, place, and purposes of this first meeting and do consent to the transaction thereof of any and all business pertaining to the affairs of the Company.

Dated 192
 A. L. WITMAN
 C. S. MEYER
 P. B. THOMPSON

If for any reason it is impossible to make use of the call and waiver of notice, the meeting may be assembled by following the statutes of the states. In the absence of statutory provision a call may be signed by a majority of the incorporators, and notice served on the subscribers to the charter not parties to the call.

Procedure at first meeting.—In securing officers for this meeting, any member may take temporary charge, appointing a chairman and secretary who will serve during the session unless objection is raised by any member. The minutes, prepared beforehand by the attorneys, serve as a program of what is to take place as well as a record of what took place. In some cases the meeting is so informal and completely worked out beforehand that a mere reading of the minutes is considered adequate if no objection is raised. Otherwise the meeting is opened, the attendance in person and by proxy is checked by the secretary; the certificate of incorporation is actually presented; the by-laws previously prepared are read and accepted entirely, or modified and accepted; directors are elected unless previously appointed in the charter, in which case they may resign and a new election take place; stock is exchanged for property to be acquired by the corporation in this manner; and any other pertinent business transacted.

2. *Regular meetings.*—The stockholders meet annually at dates specified in the by-laws, this meeting being required by law in most states. The law also provides in most instances that the stockholders meet within the state of incorporation, which usually means at the principal office. This requirement benefits the shareholders by compelling these meetings to be held in a convenient place.

The meeting is assembled by the call, which automatically exists in the by-laws, and notice, in most states, which is sent to the stockholders by the secretary of the corporation. In those states which require that notice of meetings be sent to the stockholders, failure to send such notice of any meeting seldom invalidates the proceedings of the meeting, in as much as familiarity with the by-laws' provision as to time and place may be assumed by the corporate officers. To avoid confusion and as a matter of courtesy, the notice requirements are quite uniformly observed. The following is a typical notice of the annual meeting:

NOTICE OF ANNUAL MEETING.

WITMAN ELECTRIC COMPANY.

.....Syracuse, New York,

May 1, 192....

Mr. Francis H. Jamieson
 336 Ocean Avenue
 Atlantic City, New Jersey
 Dear Sir:

You are hereby notified that the annual meeting of the stockholders of the WITMAN ELECTRIC COMPANY will be held at the office of the Company in Syracuse, New York, on.....at..... for the elections of three Directors for the ensuing year and for the transaction of such other business as may come before the meeting.

The stock transfer books of the Company will be closed atMay.....192..., and remain closed untilMay.....192....

Respectfully,

C. S. Meyer, Secretary.

By-laws frequently designate that notice be mailed, at corporate expense, a certain number of days prior to the date of meeting, to stockholders of record. As evidence that notice was served the secretary retains a copy to exhibit at the time of meeting and to spread upon the minute books. Larger corporations frequently publish notices in daily newspapers, but this form of notice is inadequate in itself since few stockholders have access to papers carrying the notice and such notice is easily overlooked by those who do have access. Reference to the typical notice reproduced above shows the date of closing and re-opening the transfer record books.

Procedure at annual meeting.—Usually the corporate officers elected by the directors preside at all meetings of the stockholders as well as at the directors' meetings, as provided in the by-laws.

The meeting is opened by the president or officer next in rank if the president is absent. Items of business are taken up in approximately the following order:

1. Roll call.
2. Proof of notice.

3. Reading of minutes.
4. Reading of reports.
5. Election of directors.
6. Other business.
7. Adjournment.

Roll call.—The by-laws provide that a specified number of shares must be represented before business can be transacted. This is known as the quorum provision. Frequently, the quorum is set at a majority, but may be set at any point by the by-laws if not contrary to the statute or charter provision. Stock may be represented by the holder in person or by proxy, in which case he delegates his rights to another party. A proxy is a special power of attorney executed by any stockholder of a corporation authorizing a designated individual to represent him at stockholders' meetings described therein. The persons to whom these powers are given are said to act as proxies. Only those capable of acting as agents for others are eligible to act as proxies. A specimen proxy follows:

PROXY.

KNOW ALL MEN BY THESE PRESENTS:

That I, the undersigned, do hereby constitute and appoint KENNETH J. JOHNSON my true and lawful attorney with full powers of substitution and revocation, to represent me at the special meeting of stockholders of the WITMAN ELECTRIC COMPANY, to be held on the.....day of.....at....., and do hereby authorize and empower him to vote at said meeting and at any adjournment thereof, for me and in my name and stead, upon the stock then standing in my name on the books of said Company, and I hereby grant my said attorney all the powers that I should possess if personally present at said meeting.

Witness my signature and seal this.....day of.....192....

MELVER M. McKIM (L.S.)

In the presence of

HENRY P. SWENTON

The proxy provision permits of greater breadth of market for stock, inasmuch as holders of stock may vote *in absentia*.

Roll call conducted by the secretary determines the number of shares represented in person and by proxy and whether or not a quorum is present. In case a quorum cannot be obtained the meeting may be adjourned until a quorum is available or until the next annual meeting, or until a special meeting has been called. In this case the directors hold over until such time as the new election takes place.

Proof of notice.—For the purpose of proving that notice has been sent to stockholders, or published in the daily press in compliance with statute charter, or by-law provisions, the secretary next exhibits a copy of the written pre-published notice.

Reading of minutes.—Though the reading of the minutes may be dispensed with upon order of the presiding officer, they are usually read. Minutes of the last annual meeting and of any special meetings held since the last annual meeting are read by the secretary, and are approved with or without correction as the occasion demands. The following set of minutes will serve as example:

THE WITMAN ELECTRIC COMPANY OF NEW YORK

MINUTES OF REGULAR MEETING OF STOCKHOLDERS.

Held.....

The stockholders of the WITMAN ELECTRIC COMPANY met in annual meeting in the office of the Company at.....at..... o'clock in the forenoon,.....

The meeting was called to order and presided over by....., President of the Company. The secretary of the company....., acted as Secretary of the meeting.

The secretary, after noting the stockholders present, reported that out of a total of 5,000 shares of stock outstanding and entitled to vote at the meeting, 4,900 shares were represented at the meeting; 3,500 shares in person, and 1,400 shares by proxies filed with the Secretary.

The secretary then read a copy of the notice of the meeting with his certificate attached showing that a copy thereof had been mailed to each stockholder of record on or before the day of..... He also presented copies of the.....under date

of.....and.....containing due advertisement of the meeting. The proof of notice as presented was ordered received and filed.

The secretary produced the stock and transfer books of the Company, together with an alphabetical list giving the name, residence and number of shares of stock held by every stockholder entitled to vote in the election of directors. This list remained open to inspection during the election of directors and for the entire time of the meeting.

The minutes of the preceding annual meeting were then read and approved. The minutes of the special meeting of stockholders held.....were also read and approved.

Upon motion duly seconded and carried,and.....were appointed Inspectors of Elections, were duly sworn, and the meeting then proceeded to the election of Directors. The election was held by ballot, and the polls were opened at 10:15 A. M. and closed at 11:15 o'clock A. M.

The Inspectors thereupon presented their report in writing showing that,,, and had received a plurality of all the votes cast, and the said parties were then declared to be the duly elected Directors of the Company for the ensuing year and until the election of their successors.

The annual report of the President was then presented and upon request was read by him. The report was by unanimous motion ordered received, and filed.

The Treasurer's annual report was submitted, and, no objection being offered was ordered received and filed.

The report of the committee appointed at the special meeting of stockholders held.....to examine the accounts of the Company, was received and by motion its findings were approved and the report ordered received and filed.

Upon motion duly made and unanimously adopted, the Board of Directors were authorized to secure plans and estimates for enlarging the plant of the Company.

There being no further business before the meeting a motion to adjourn was unanimously adopted.

.....
President.

.....
Secretary.

The minute book.—The minute book contains, in addition to the minutes of the regular and special meetings of stockholders and directors, authenticated copies of the articles of incorporation and by-laws. It may be either

a bound or a loose-leaf book, each form having its advantages and disadvantages. As it is the official record of meetings, adequate safeguards against tampering with or destroying the book must be provided.

Reading of reports.—Officers or committees, or both, may have reports to make to the assembled stockholders. The president, or treasurer, usually renders the annual report covering the activities and financial condition of the enterprise, while the chairman of the board of directors, if any, or of any standing committee of the board may submit reports. These reports may be discussed, accepted, corrected or revised, and spread on the minute book or otherwise disposed of.

Election of directors.—In small corporations where the same directors are acceptable year after year, the election of directors may be dispensed with, the old board continuing in office. In large corporations, on the other hand, the election of directors constitutes the most important item of business transacted at the annual meeting.

Usually the annual election of directors is conducted by two inspectors of election, neither being a candidate for the office of director. These inspectors are chosen at each annual meeting of the stockholders to serve the ensuing year and in case of absence of inspectors others are appointed in their place. The inspectors have entire charge of election, and are sworn to faithfully perform their duties. After the election they make a written certification of the result of the election. The minimum number of votes required to elect is specified usually in the by-laws.

Voting is done by ballot, which may be a by-law provision, but which is frequently a requirement of the statutes. A sample inspection certificate or report appears on page 161.

Other business — adjournment.—Any other business which may come before the meeting is, finally, taken up. This may be either unfinished business remaining from the last regular or special meetings which may have been referred to committees, or new business.

The meeting may finally be adjourned by the presiding

INSPECTOR'S CERTIFICATE

The undersigned inspectors of election appointed to act at the annual meeting of the stockholders of the WITMAN ELECTRIC COMPANY, Inc., held at Syracuse, New York on, report that, after taking and subscribing to the oath prescribed by law in such cases impartially to conduct the election for directors for the said meeting we did receive and canvass the votes cast at the said election, and by these presents certify the result of the election to have been as follows.

Name	Votes Received
WITMAN
THOMPSON
MEYER

In testimony whereof we have hereunto set our hands this.....day of
.....A.D.....

.....
.....
Inspectors

officer or by vote of the stockholders. In case the business has not been completed, adjournment may be effective until such future convenient date as is decided upon by vote.

3. *Special meetings.*—Frequently, between annual meetings, matters arise demanding the immediate attention of stockholders and necessitating a special meeting. Special meetings, in the matter of procedure, are similar to the annual meetings. There are, however, several points of difference. These differences have to do with:

- 1. Method of assembling.
- 2. Action taken by stockholders.

Method of assembling.—Obviously no provision could be included in the by-laws as to the time of special meetings. They must, therefore, be officially called. The usual provision states that they may be called by resolution of the board of directors, by the president, or by the secretary upon written request of the majority of the board of directors or stockholders. Notice must then be sent to the stockholders.

Action taken by stockholders.—The annual meeting may consider any business which might reasonably or legally be transacted. Action taken at the special meeting, however, must be confined to business specifically designated in the call and notice. If the group of stockholders is small, the call and waiver of notice, signed by all, may be employed, as was done in the stockholders' organization meeting.

Problems.

1. "As the Federal Constitution is the fundamental law of the land, so is the corporation charter the fundamental governing set of rules of the corporation." Explain what is meant here.

2. What other federal rules correspond in some respects to the corporate by-laws?

3. Illustrate by using the Eighteenth Amendment and the Volstead Act.

4. Into what four classes do we place the main details which go into the by-laws?

5. Mention the specific details which go into the by-laws.

6. How do the various meetings of the stockholders as outlined in the by-laws differ as to:

(a) Method of assembling?

(b) Procedure?

CHAPTER XII

THE BY-LAWS: PROVISIONS AS TO DIRECTORS

In Chapter X, an analysis was made concerning the usual charter provisions defining and limiting the activities of directors. Frequently some of these provisions find their way into the by-laws instead of the charter, and in some cases, statutes permit the inclusion of provisions in either the charter or by-laws. It may be safely assumed, however, that the routine functioning of the board is mapped out in the by-laws and it is with this problem that we are now concerned.

Meetings of the Board.

As in the case of stockholders the directors have three types of meetings:

1. Organization meetings.
2. Regular meetings.
3. Special meetings.

The normal by-law provisions relating to these meetings have to do with the method of assembly, the time and place of meeting, and in some cases the procedure to be followed.

The organization meeting.—Either of two methods of assembling this meeting may be employed, the “call and notice” or the “call and waiver of notice.” There are, as yet, no corporate officers, and consequently no secretary to send out call or notice. The call may, however, be issued by the directors, signed by a majority of them, or, as is usually the case, the meeting may be assembled by a call signed by the entire group and waiving further notice. Such call and notice or call and waiver notice contains

the time and place of meeting, together with a program of procedure.

It is customary for the board of directors to meet to elect officers and for the transaction of any other business as soon as practicable after the organization meeting of the stockholders, and at the place where the stockholders' meeting was held. The usual order of business at this meeting is as follows:

1. Opening of the meeting.
2. Proof of authorization.
3. Roll call.
4. Election of officers.
5. Adoption of stock certificate.
6. Exchange of stock for property.
7. Recognition of subscribers.
8. Determination of treasurer's bond and depository.
9. Other business.

The general procedure is similar in both stockholders' and directors' meetings but certain differences require brief analysis.

Procedure in first meetings.—Any director may assume charge of the organization meeting, in as much as there have been no officers elected. A temporary chairman may be appointed by the director in charge or elected by the group, who in turn appoints a temporary secretary to fill that office. In the regular and special meetings the permanent officers of the corporation to be elected in the organization meeting will preside.

The temporary secretary calls the roll and determines whether or not a quorum, as specified in the by-laws, is present. This quorum may be any proportion desired but in some states laws specify a minimum below which it cannot be placed. The call, or call and waiver of notice, is next exhibited showing proof of authorization of the meeting.

Election of officers.—The principal item of business is the election of officers, president, vice-president, secretary, treasurer, and sometimes, a chairman of the board. If, as is almost invariably the case, the officers of the

corporation are to be elected by the board, their election is the first business before the meeting. The by-laws already adopted by the stockholders usually designate the officers to be elected and the manner of their election, and these requirements should be strictly followed. Generally the election is by ballot. Candidates for the various offices might be severally nominated with due second thereto, but when, as is usually the case, all these candidates have been agreed upon in advance, formal nominations are dispensed with and the details of election taken up at once. Where all are agreed, a motion is frequently passed instructing the secretary to cast the single ballot of the meeting for the recited list of officers. This is proper and at times convenient. If the election is to be carried out in detail, the presiding officer will, in the absence of objection, appoint tellers. The members of the board then prepare their respective ballots and the tellers collect and count these ballots and announce the results. Each officer may be balloted for separately, or, as is usually the case, one ballot be made to serve for all the officers.

The newly elected officers take charge of the meeting as soon as their election is determined. If, by any chance, they are absent from the meeting or are unable to assume their official duties immediately, the temporary officers already in charge will continue to serve until the meeting has adjourned or until the newly elected officers are ready to take charge. In some states the law requires that the secretary be sworn to fill his office faithfully. This formality should be met with before the officer assumes his office, although failure to do so does not affect the legality of the meeting or the value of his records.

Adoption of stock certificates.—The form, color, engraving, quality and content of the stock certificate may be determined by either the stockholders or directors. It is customary, however, to leave the choice to the board of directors assembled for their first meetings.

Exchange of stock for property.—It frequently happens that certain of the subscribers to the capital stock of the corporation have given property of some sort, such as land, buildings, patents, etc., in exchange for shares of

ownership in the enterprise. This exchange is usually formally ratified at the organization meeting of the directors, having previously been ratified at the first meeting of the stockholders.

Recognition of subscribers.—In a state where subscriptions to stock made prior to organization are interpreted as being continuing offers, the contract is consummated by acceptance of subscriptions by the directors at their first meeting. This recognition is confined to subscribers to stock who were not incorporators and who did not, therefore, participate in the preparation and execution of the charter.

Treasurer's depository and bond.—The bond requirement may be contained in either the statutes of the state, or in the corporate charter or by-laws. For example New Jersey laws provide that bond must be furnished but determination of the amount is reserved for the by-laws. In a number of states permission is given to include the bond requirement in the charter or by-laws, the provision usually being placed in the by-laws. In such case the by-laws may specify a definite amount to which the treasurer shall be bonded, or, as is more commonly the case, they may leave the determination of the size, nature of surety, etc., to the wisdom of the directors.

The nature of bonds will be considered further in connection with the duties of the treasurer.

Other business.—Any other business which must be attended to immediately by the directors is properly transacted at the first meeting. These items frequently concern the payment of expenses incident to organization, such as organization and lawyers' fees, and questions of general business policy. In case time does not permit completion of business which should be transacted, it is common practice to adjourn the meeting with the idea of resuming the procedure later.

Regular meetings.—The directors meet at regular intervals at times and places specified in the by-laws. The statutes of some states require that meetings be held within the state or, that they be held within the state unless exception is made in the by-laws. When by-laws

grant the right to hold meetings without the state it is common practice to permit the directors to specify the place of meeting, with occasional limitation. For instance the by-laws of the National Cash Register Company, permit directors to assemble in regular or special meeting within or without the state of Maryland, but limit the cities outside the state, at which meetings may be held, to New York and Dayton, Ohio.

The time of meeting may be left to the discretion of the board of directors, as in the sample by-laws presented elsewhere, or may be accurately stated in the by-laws. The frequency of regular meetings may be determined by the size and nature of the business, and, in some instances, by the size of the board of directors, and the degree to which executive committees are employed. Monthly or quarterly meetings are the rule in the larger enterprises. One set of by-laws specifies an annual meeting of the board for election of officers in addition to quarterly meetings to be held at stated times.

Notice may or may not be necessary for assembling regular directors' meetings, depending upon the by-law provisions. Courtesy, however, demands that each director be notified, whether or not notice is required; and good business policy dictates that such notice be served in order to secure, as far as possible, a full attendance, or at least a quorum. Notice given, or waivers taken over the telephone, while informal in the extreme, are frequently employed, simplifying the problem of assembling directors' meetings.

Business transacted at the regular meetings of directors relates to general policy determination. Either the president or the chairman of the board, if such officer exists, presides with the secretary acting in his usual capacity. Roll call and determination of a quorum require much less attention than in the meetings of stockholders. The quorum requirements for directors are found, as in the case of requirement for stockholders, in the by-laws and may be set at any point desired excepting where the statute establishes a minimum number. For example, New York requires that the minimum quorum require-

ment be one-third of the membership of the Board. Roll call is followed by the reading of minutes of the last regular or special meetings, and the report of committees, such as the executive or finance committees. Matters of business policy are next disposed of and, when necessary, officers are elected. This election may be formal and conducted by ballot, or informal and conducted by a more or less general acquiescence. New officers usually assume their offices immediately after election. Dividend policies are determined at regular intervals. Upon disposal of all business adjournment is in order.

Special meetings.—Necessity may require that directors assemble for the purpose of disposing of special business before the time of the next regular meeting. The procedure at these special meetings is similar to that in the regular meeting excepting that the business transacted must correspond exactly to that named in the special notice which is required. Special meetings may as a rule be called by the president, upon a specified number of days' notice, fixed in the by-laws; or by the president upon written request of a number of directors, specified in the by-laws; or by resolution of the directors or by a number of stockholders fixed by the by-laws. It becomes the duty of the secretary to send notices to the directors that the special meeting has been called and to specify the exact nature of the business to be transacted.

Problems.

1. Compare the various meetings held by the directors as to:
 1. Method of assembling.
 2. Procedure.
2. Mention any differences which exist between the various meetings of stockholders and directors, other than items of business transacted.
3. Draw up a by-law provision for the Artificial Honeycomb Corporation describing the place where its directors' meetings may be held.
4. Why is it more common to describe in greater detail the place where directors may meet than where stockholders may meet?

CHAPTER XIII

THE BY-LAWS: PROVISIONS AS TO OFFICERS

The fictitious personality of the corporate form of enterprise requires a human agency for the determination and execution of business policies. The determination of policies is in the hands of the directors, and their execution is secured through the appointment or election of officers by the board of directors. It is customary for state laws to provide that these officers shall consist of a president, one or more vice presidents, a secretary, treasurer, and other officers, such as a chairman of the board of directors who has powers and duties in the corporate management, subject to the control of the directors as prescribed by them, or in the by-laws. In addition the statutes usually set forth the liabilities of officers as in the case of the directors. Aside from these provisions the statutes usually have little to say concerning the corporate officers. Likewise, the charter offers little by way of regulation.

Thus the designation of the rights, powers, duties and limitations of officers may be found quite uniformly in the by-laws of the corporation, where the degree of control may be minutely specified, or where such control may be left largely to the prudence of the directors. The latter plan affords greater flexibility of management on the part of the directors and consequently may be considered the better plan. The usual provisions have to do with a designation of the offices to be filled, qualifications of officers, powers and duties attaching to these offices, the tenure of the office in each case, the compensation of officers, and the bond and depository requirements. The usual provisions relating to corporate officers will be analyzed in the following pages.

The Corporation President and Vice President.

The qualifications of officers are determined by the board of directors, subject to any by-law requirements. The requirement placed in the by-laws reproduced in chapter XII provides, for example, that the president and vice president be selected by the directors from among their own numbers.

As a rule the president has as his function the presiding at all of the meetings of stockholders and directors. He may also be given the management of the business, and entrusted with the execution of all orders and resolutions of the directors except those which may be delegated by the board to other officers. Where the corporation is large it is customary to elect a chairman of the board who presides at board meetings in place of the president. In addition the president frequently signs or countersigns documents, as in the case of stock certificates, dividend checks, etc., and prepares annual reports on the condition of the affairs of the corporation for the stockholders and directors. The general function of a vice president is to perform the duties and exercise the functions of the president in case of the latter's absence for any cause. It is not uncommon to find a corporation having several vice presidents, one in charge of production, one in charge of sales, a lawyer who acts in the capacity of counsel, and so forth. In this use, the term "vice president" is used only to dignify the positions to which they are attached.

The Corporation Secretary.

In the small corporation it is a common practice to combine the office of secretary and treasurer into one. In large organizations greater efficiency is secured by keeping the offices separate. In either case, the secretarial duties are similar to, and are in general, the duties of any secretary of any organization. Specifically, he attends all board meetings and stockholders' meetings in the role of clerk, checks the attendance, writes up the minutes of the meetings and records all votes. He sends

all notices to stockholders and directors, retains custody of the corporate seal, affixing it to documents or instruments upon authority from the board of directors or executive committee. Unless outside agents are employed, it becomes the duty of the secretary to keep the stock transfer records, described elsewhere, and to prepare lists of stockholders required by the statutes or by the corporation.

The reports, required by law, to be returned to the office of the secretary of state or other office, are prepared by the secretary. These reports may concern taxation, finance, additional stock issues, amendment of by-laws or charter, applications to do business in other states, or to sell stock under "blue-sky" law provisions and numerous other subjects.

The Treasurer.

The treasurer is the custodian of corporate funds, and as such receives and disburses moneys, and attends to financial details of the corporation. With few exceptions, notably Massachusetts, where his election is in the hands of the stockholders, the treasurer is elected by the board of directors. The principal definition of his duties is found in the by-laws, although sometimes state statutes set up certain requirements, as in the case of New Jersey where the bond requirement is statutory. In other states this requirement is usually permissive in the statutes and mandatory in the by-laws, but only rarely so in the charter.

As a matter of routine the treasurer is usually required, on behalf of the corporation, to endorse for collection checks, notes and other obligations and to deposit them to the credit of the corporation in a bank or banks, known as depositories, previously selected by the directors or finance committee. He is required to keep account books containing records of receipts and disbursements, and to render statements of cash accounts upon request of the directors. In case of disbursement of funds, such as the payment of dividends and bond inter-

est, the treasurer signs checks, which are countersigned by the president or some other designated official.

The treasurer's books.—The books of account kept by the treasurer vary, the size of the corporation being a large factor in determining their scope. In a small corporation the office is likely to include the functions of accounting and possibly of collection of funds. In such case it might be necessary for a treasurer to have a knowledge of accounting in addition to his qualities as treasurer. In a large concern, on the other hand, his chief virtue may be his financial standing and reputation, and his detailed duties few. In any case, his office should be able to show moneys received and disbursed, and the resulting balance. The duties of the treasurer may, therefore, vary between these two extremes.

Assuming the treasurer's office.—Upon assuming office the treasurer gives bond guaranteeing proper performance of his duties. The retiring treasurer surrenders his books of account and other corporate property to his successor. The new treasurer checks over the property to ascertain whether or not the amount corresponds with the records and if so gives the outgoing officer proper receipts.

In order to establish his identity at the depository, the new treasurer immediately notifies the bank of his assumption of office and has the funds transferred to his account as treasurer. In case the funds have been deposited in the name of the corporation, no such transfer is necessary.

The treasurer's bond.—The treasurer's position is one of trust, and in as much as his acts may bring about financial loss to the corporation, to the stockholders, or to outside parties such as creditors, he is required by some state laws to furnish bond covering possible loss, and in most corporations the by-law provisions fix a similar requirement, even though the statute may be silent on the subject. Despite the fact that the treasurer may be chosen on account of his integrity and financial standing, and surrounded by checks on his activity in the form of frequent audits of his books, countersignature require-

ments, and so forth, the added bond requirement is usually exacted.

There are two forms of satisfactory bonds, the personal bond and the surety bond. In either case the treasurer secures a third party who is willing to insure the corporation against loss on account of faulty performance of duty on the part of the treasurer. If the personal bond is used, the guarantee is made by an individual, probably a friend of the treasurer, who is willing to risk a portion of his fortune on the integrity, accuracy and ability of the officer being bonded. This form of bond may not be so acceptable to the directors on account of the possibility of loss in case the bondsman should eventually become insolvent. In addition, it is the frequent policy of courts to be less rigid in the matter of forcing payment by a personal bondsman than in the case of a surety bondsman.

The surety bond is a guarantee supplied by a company organized for the purpose of furnishing bonds, and charging a fee, in much the same manner as an insurance company furnishes life insurance. The thing insured is honesty and faithfulness, the corporation being the beneficiary and the treasurer being the insured. Bonds are furnished for any employee entrusted with money or other property, and the fees differ with the degree of risk involved.

The surety bond is more readily acceptable to the directors despite the cost of securing it. The amount fixed in the by-laws or by the directors is dependent upon a number of factors. In the first place the treasurer may be of high financial standing and, since he signs the bond with the surety company, thus placing the corporation in a more advantageous position, the bond requirements may be small. In addition, the amount of the bond varies inversely with the number of checks placed about the treasurer in the form of audits, countersignatures, and so forth. A third determining factor is the amount of funds which the treasurer may handle, either the maximum amount or average amount usually in his custody.

In case the treasurer should neglect his duty in any

way, or perform it in a faulty manner, thereby causing the corporation, the stockholders, or the creditors to experience a loss, the bondsman must make good the amount of loss sustained, but only up to the amount guaranteed in the bond.

The treasurer's depository.—The by-laws may make specific designation of the bank or trust company in which the corporate funds are to be deposited, but the common procedure is to leave such designation to the resolution of the board of directors. This is usually done at the first meeting of the directors. A copy of the resolution, together with the signatures of the officers authorized to sign or countersign papers, should be furnished the depository upon opening the account.

Problems.

1. Draw up the by-law provisions of the Artificial Honeycomb Corporation as they apply to:
 - a. The president.
 - b. The secretary.
 - c. The treasurer.
2. What are some common safeguards thrown about the office of treasurer? Should the secretary be bonded?
3. Describe the treasurer's bond and depository in detail.
4. Outline the essential qualities and characteristics of a good treasurer.

CHAPTER XIV

THE BY-LAWS: STOCK

In the charter we found the provisions which set forth the capitalization structure of the corporation essentially, the amount, nature and classification of the capital stock to be authorized. In the by-laws, provision is made for a transfer system, a system made necessary by the advantage given to the corporation whereby its shares, unlike partnership shares, may be freely bought and sold in any market without dissolving the corporation. If the properties which go with stock ownership are to be exercised, it is obviously necessary for the corporation officers to have exact knowledge of the personnel of the stockholding group. In the main these properties are votes, dividends, and participation in asset distribution upon liquidation. This problem resolves itself into three parts:

1. Stock records.
2. Methods of transfer.
3. Care in transfer.

In addition, the statutes of some states make it necessary to give consideration to:

4. Transfer taxes.

Stock Records.

The usual books of record for transfer kept by a corporation are:

1. Stock certificate book.
2. Stock ledger.
3. Stock transfer book.

Certificate No. 154

For 46 Shares

Issued to:

W. J. Evans,

800 Park St.,

Syracuse, N. Y.

Dated, **February 1, 1928**

From Whom Transferred:

Original Issue

No. Original Certifi- cates	No. Original Shares	No. of Shares Trans- ferred

Received Certificate No. 154
for 46 shares, **February 1,**
1928,

W. J. Evans.

No. 154

46 Shares

Incorporated Under the Laws of The State of New York.

THE WITMAN ELECTRIC COMPANY, INC.

Capital Stock\$800,000
Common Stock 500,000
Preferred Stock 300,000

FULL-PAID, NON-ASSESSABLE

This is to certify that **W. J. Evans** is owner of Forty-six Shares of the capital stock of THE WITMAN ELECTRIC COMPANY, INC., transferable only on the books of the company by the said owner thereof, in person or by duly authorized attorney, upon surrender of this certificate properly indorsed.

{ CORPORATE }
{ SEAL }

Witness the seal of the company and signatures of its duly authorized officers, this first day of February, 1928.

C. S. MEYER,
Treasurer.

A. L. WITMAN,
President.

—Shares \$100 each—

In some cases, such as in small enterprises where there is little transfer of stock, one or more of these books may be used, but in some states the laws require that all three be used. This situation will be dealt with in subsequent discussion.

The stock certificate book.—This book is essential in all corporation stock issues. The stock certificate is the document held by stockholders as convenient evidence of ownership of shares. One certificate may represent any number of shares. In as much as the transfer records rather than the certificates are the final authority of ownership, it is necessary that such records be carefully and accurately maintained.

The stock certificate book, in addition, is the book of original entry. It is, in form, a larger sort of check book, similar to those used in drawing bank checks, and, like a check, the certificate is torn from a stub, each stub bearing the same serial number as the certificate torn from it. When the form of this book has been chosen beforehand, the certificates are issued immediately upon completion of organization. Otherwise temporary evidence is given to owners until such time as permanent certificates have been prepared. The figure on the opposite page is an adequate representation of a stock certificate prior to separation from its stub.

The stock ledger.—The stock ledger functions in much the same way as an ordinary ledger in financial accounting, with the exception that it is kept in greater detail. It becomes possible with the use of a ledger to determine at any instant the exact holdings of any shareholder by balancing the shares acquired against those disposed of. The following ledger adapted from one used by a Mid-West manufacturing company will illustrate the point, and will be more fully considered in connection with methods of transfer.

Frequently corporations keep separate ledgers for common and preferred stock in order to avoid as much confusion as possible. The form of ledger sheet may vary, as many explanatory columns being used as are deemed necessary.

DATE	FROM OR TO WHOM TRANSFERRED	CERTIFICATE NUMBERS		NUMBER OF SHARES				REMARKS
		<i>Can- celed</i>	<i>Issued</i>	<i>Dr.</i>	<i>Cr.</i>	<i>Re- issued</i>	<i>Bal- ance</i>	

The stock transfer book.—The stock certificate usually bears, on its face, the statement “transferable only on the books of the corporation.” Upon every transfer of stock the seller is required to sign this book, either in person or through the use of a power of attorney. A page from the transfer book would read as follows:

Ledger Folio	Transfer No.....
<p>THE WITMAN ELECTRIC COMPANY, INC.</p> <p>For value received, I hereby sell, assign and transfer unto..... shares of the Capital Stock of the above mentioned company, now standing in my name on the Company books and represented by surrendered Certificate Nos.....</p> <p>New Certificate No.</p> <p>Issued to</p> <p>Ledger Folio Attorney</p>	

Methods of Transfer.

Let it be supposed that W. J. Evans holds a certificate representing forty-six shares in the Witman Electric Company, Inc., and desires to sell his entire interest to H. S. Cole, who is not a stockholder. When the secretary of the corporation made the original issue he made the proper entry on the stub corresponding to the certificate

issued. This data would be posted to the ledger account for Mr. Evans which would appear as follows:

W. J. Evans, 800 Park St., Syracuse, N. Y.								
DATE	FROM OR TO WHOM TRANSFERRED	CERTIFICATE NUMBERS		NUMBER OF SHARES				REMARKS
		<i>Can- celed</i>	<i>Issued</i>	<i>Dr.</i>	<i>Cr.</i>	<i>Re- issued</i>	<i>Bal- ance</i>	
1927 Jan. 14	Original		154		46		46	

When the transfer is made from Mr. Evans to Mr. Cole, Mr. Evans first fills in the assignment blank on the reverse side of the stock certificate which reads:

For Value Received **I** hereby sell and transfer unto **H. S. Cole, Forty-six (46)** Shares of the Capital Stock represented by the within Certificate, and do hereby irrevocably constitute and appoint **R. Hale** my attorney to transfer the said stock on the books of the within named Company with full power of substitution in the premises.

Dated, **February 1, 1927**
In presence of **L. A. Martin**

W. J. Evans

This may be done in other ways to be explained later. The certificate duly assigned is then delivered to Mr. Cole who presents it to the corporation secretary or other transfer agent for transfer. The secretary stamps the old certificate "canceled," pastes it on the stub from which it was originally taken, and makes the proper entry on the stub and in the ledger accounts which would now appear as indicated in the form on the next page. Where the corporation employs a transfer agent, this detail might be taken out of the hands of the secretary of the enterprise.

W. J. Evans, 800 Park St., Syracuse, N. Y.								
DATE	FROM OR TO WHOM TRANSFERRED	CERTIFICATE NUMBERS		NUMBER OF SHARES				REMARKS
		<i>Can- celed</i>	<i>Issued</i>	<i>Dr.</i>	<i>Cr.</i>	<i>Re- issued</i>	<i>Bal- ance</i>	
1927 Jan. 14	Original		154		46		46	
Feb. 1	H. S. Cole	154	519	46		46	0	

Assuming that Mr. Cole has never before held stock in the Witman Electric Company, Inc., the secretary or other transfer agent would set up a ledger account for him, making the following entries:

H. S. Cole, 241 Lincoln Dr., Syracuse, N. Y.								
DATE	TO OR FROM WHOM TRANSFERRED	CERTIFICATE NUMBERS		NUMBER OF SHARES				REMARKS
		<i>Can- celed</i>	<i>Issued</i>	<i>Dr.</i>	<i>Cr.</i>	<i>Re- issued</i>	<i>Bal- ance</i>	
Feb. 1	W. J. Evans	154	519		46		46	

Mr. Evans signs the transfer book either personally or through the power of attorney given in the assignment blank, and the transfer is completed. Mr. Cole is now "the stockholder of record" in place of Mr. Evans.

The problem becomes somewhat more involved if Mr. Evans desires to sell to Mr. Cole only a fraction of the shares represented on his certificate. The procedure of transfer under this condition may follow either of two

paths. The better way is for Mr. Evans to execute the assignment on the reverse side of the certificate, directing the secretary to issue him two new certificates, one having title to the number of shares to be transferred to Mr. Cole, the other containing title to the remaining shares. Mr. Evans now assigns the proper certificate, delivers it to Mr. Cole, who submits it to the secretary for completion of transfer.

A less preferable method, though one involving fewer steps, is for Mr. Evans to assign the certificate to be split up, directing that a new certificate for the number of shares to be transferred be issued directly to Mr. Cole, the remaining shares to be re-issued to himself on a new certificate. Obviously the former method is safer, while the latter is much simpler. Under the second method, even though Mr. Cole fails to take delivery, he is the stockholder of record with all rights attached thereto.

Methods of assignment.—There are three possible methods of assigning or endorsing stock certificates: assignment in blank, assignment in full, and the method described in the next paragraph. In the first case the seller merely signs his own name without inserting the name of the purchaser or transferee, and gives up the document to the purchaser. In the second case the blank is completely filled in before delivery, making it necessary for the purchaser to surrender the certificate to the transfer agent of the corporation in exchange for a new one made out to the purchaser to whom he would deliver the new document.

Sometimes the stock certificate comes into the possession of the transferee without endorsement, but accompanied by a separate instrument of assignment or power of attorney with the same effect as though the assignment in blank on the reverse side of the certificate had been completed.

The advantage of the first method lies in the fact that it may be freely passed from hand to hand without surrender to the corporate transfer officer each time, and is convenient in case the stock is speculative rather than investment stock. Any one wishing to become the “stock-

holder of record" on the transfer books of the corporation may do so by merely inserting his own name as transferee and surrendering the certificate for transfer on the company's records. In case of loss, moreover, it is easy for the finder to insert his name as transferee and become a stockholder of record, causing a great deal of trouble to the rightful owner, who wishes to reclaim his ownership. Safety, therefore, demands a complete assignment, wherever safety is the dominant interest.

In case the power of attorney blank is left vacant, the secretary of the corporation has implied authority to sign the transfer book in the place of the transferor or transferee.

Transfer requirements.—The transferability of shares in a corporation is one of its principal virtues and should be unrestricted in freedom. There are instances, however, when the transfer agent can temporarily hold up any change of record on his books. When dividends are to be distributed to stockholders of record, the books are "closed" during the period necessary to make up a list of those entitled to dividends. The books are likewise closed in preparation for stockholders' meetings. This period, specified in the by-laws, varies in different organizations, depending on the degree of stockownership, both in size and width of distribution.

It is a fundamental principle that a corporation is liable for the total market value of any stock transferred on its books where "due authority" has not been proved by the transferee. The danger of faulty transfer is probably more acute in the case of the smaller corporations, where the relative infrequency of transfer and intimate knowledge of the personnel of the stockholding group generates confidence in the infallibility of the transfer officers. Large corporations, on the other hand, strengthen their positions by the employment of outside transfer agents, similar to the ones described in chapter VI, to take care of all transfer records, their own officials merely keeping a check on the accuracy of the agent employed. These specialist companies do not insure the corporation against faulty transfer, but merely recommend their services on

the grounds that their experience, analysis of statutes, court decisions, etc., reduce the probability of error.

Examples of faulty transfer.—The case of a transfer by the officers of the old Wilmington and Raleigh Railroad company of stock assigned by one John Baker, and presented for transfer by the purchaser, illustrates the cost of faulty transfer due to carelessness. An apparently simple case of transfer turned out to possess baffling complications by virtue of the fact that the certificate presented was one bequeathed by a grandfather to John and Jesse Baker, under a will which provided that, should either of these brothers die without heirs, the survivor was to come into possession of the stock, and in case both should die without heirs, the stock was to go to the next of kin. Jesse died without issue and John sold the stock which was transferred to a new owner on the books of the railroad company. Subsequent to the transfer, John, too, died without issue, and the stock was claimed, under the provisions of the will, by the next of kin, who, after litigation, succeeded in establishing his ownership. Since he was an innocent purchaser, the person to whom John Baker had sold the stock could not be compelled to relinquish his right, the only possible settlement remaining being a payment to the "next of kin," amounting to the market value of the stock. Failure on the part of the transfer agents to secure a knowledge of the contents of the will was held by the court to be no reason for making such a mistake. Obviously, special care is necessary where stock is transferred by power derived from a will or other fiduciary relationship, and the authority granting the transfer should be minutely scrutinized. Even with careful scrutiny and the utmost care, error is likely to arise in stock transfer on the corporate records. For example, a shareholder, living in Indiana, died leaving as a part of his personal estate, 308 shares of stock in a public utility located in the city of Indianapolis. Eventually these shares, assigned by the administratrix of the estate, were presented by the purchaser for transfer on the corporate transfer books. With great care the transfer agent discovered that the administratrix had secured

the right from the court to sell the stock, a right required under the law of Indiana, and consequently proceeded to alter transfer records accordingly. It was, however, later discovered that, while the administratrix had secured the court order to sell the stock, she had failed to negotiate the sale in accordance with the terms of the order, with the result that the sale was held by the court to be illegal, so that the estate still retained title to the stock. The corporation was ordered to restore the title in the stock to the estate or to reimburse the legal owner in cash.

These cases might be indefinitely multiplied to illustrate the numerous dangers incident to the corporate liability for errors in stock transfer. Sufficient evidence has been presented, however, to prove the helplessness of the transfer agents in detecting the hidden complications which might escape the most minute examination and investigation. It is also apparent that the danger lies, not in the very *doubtful* cases, but in those that bear, superficially at least, all the earmarks of *simplicity* and *legitimacy*.

Transfer tax.—All original stock issues are taxed by the United States government at the rate of 5¢ per share of \$100 par value or fraction thereof, and 2¢ on subsequent transfers. A few states¹ have a similar 2¢ transfer tax. In the case of shares having no par value, the rate is 2¢ per share. In all cases, the tax is paid by the seller. In collecting the tax, it is the duty of the person or persons making the sale or transfer to procure, affix and cancel the stamps, and pay the tax provided by the law. It is not intended to impose a tax upon an agreement evidencing the deposit of certificates as collateral security for money loaned thereon, which certificates are not actually sold, nor upon such certificates so deposited, nor upon mere loans of stock or certificates or the return thereof. The payment of such tax must be denoted by an adhesive stamp or stamps affixed as follows: In the case of a sale or transfer, where the evidence of the transac-

¹ New York, Massachusetts, Pennsylvania, and South Carolina. Only South Carolina levies a tax on original issue.

tion is shown by the books of the association, company, corporation, or trustee, the stamps shall be placed upon such books, and it shall be the duty of the person making the sale or transfer to procure and furnish to the association, company, corporation, or trustee, or affix and cancel, same. Where the transaction is affected by the delivery or transfer of a certificate, the stamps shall be placed upon the surrendered certificate, and canceled; and in case of an agreement to sell, or where the sale is affected by delivery of the certificate and signed in blank, there shall be made and delivered by the seller to the buyer, a bill or memorandum of such sale to which the stamp shall be affixed and canceled. Every such bill or memorandum of sale or agreement must report the name of the seller, the stock, or the certificate, to which it relates, and the number of shares which it represents. All such bills or memoranda of sale shall bear numbers upon their faces and no more than one such bill or memorandum of sale made by the seller on any given day shall bear the same number. This identification number of the bill or memorandum of sale must in all cases be entered and recorded in the book of account required to be kept by the law, and no further tax is imposed upon the delivery of the certificate, or upon the actual issue of a new certificate when the original certificate is accompanied by the duly stamped memorandum of sale as required.

The Uniform Stock Transfer Act.

In the past, stock has been only partially negotiable owing to the uncertainty of common law provisions in states where they prevailed, or to the variation in state statutes governing transfers. As a result, an act was devised some years ago for the purpose of placing stock in the class of all other negotiable instruments, the act being called the "Uniform Stock Transfer Act." Most of the leading incorporating states have accepted the act so that we may, in general, speak of corporate stock as being in the class of all commercial paper, so far as negotiability is concerned.

The Use of Stock as Collateral.

The negotiability of stock under the provisions of the Uniform Stock Transfer Act makes it possible to use such stock as collateral for loans at the bank to the same degree that bonds, bills of lading, warehouse receipts, and other commercial paper are used. The degree of completeness of transfer varies in different instances. A common practice is to have the owner of the stock assign the certificate in blank and deposit it as security with the lending bank. This makes it possible for the pledgee to sell the stock to satisfy his claim in case of default, while continuing the rights pertaining to the stock, such as voting and dividend rights, in the hands of the pledgor.

Sometimes the pledgee has the stock actually transferred to him on the corporate records, with the designation "pledgee" following his name on the new certificate to identify him in his true relationship to the stock and the corporation. Some provision is usually made for the pledgor to maintain his right to votes and dividends in either case, such provisions being frequently required by state statutes.

Problems.

1. You purchase five shares, par value \$100, in the Artificial Honeycomb Corporation. Draw up a sample sheet from the stock certificate book, showing what entries the secretary would make on the stub and certificate.

2. Draw up a sample ledger sheet showing the entries for your purchase.

3. Compute the amount of federal transfer tax which would be paid. Who would have to pay it?

4. Six months after your purchase you desire to sell three of your shares to F. A. Weaver. Indicate two ways of assignment of the certificate. Which one would be better for you to use? Why?

5. Set up ledger accounts for yourself and Mr. Weaver to show two methods of transfer which would be possible, indicating which one you would use, and explaining why you would use that particular method.

6. How much transfer tax would be paid, if the transaction

takes place in the state of New York, New Jersey, Pennsylvania, or South Carolina? How much in other states?

7. Who would pay the above tax?

8. Explain the care necessary, on the part of the corporation, in making this transfer.

9. How might the Artificial Honeycomb Corporation make use of a transfer agent? A registrar?

CHAPTER XV

THE BY-LAWS: DIVIDENDS

In the course of successful productive operation of any business enterprise, profits accumulate. These accumulated profits accrue to the owners of corporate shares and are distributed in the form of dividends from time to time to such owners at the discretion of the directors. In case the directors do not see fit to distribute the profits, they need not do so, provided, of course, they are acting in good faith. A typical by-law provision reads:

The directors may declare dividends out of the profits of the corporation at such times and in such amounts as the board of directors may from time to time designate.

The by-laws may fix adequate checks upon the directors in the matter of dividend declaration, such checks being either rigid or flexible, and based upon the wisdom of the members of the board. These checks usually pertain to the setting aside out of net profits of reserve funds to meet contingencies, equalize dividends, or to provide for depreciation, sinking funds, or other reserves. All or any of these may be either mandatory or discretionary.

The Problem of Dividends.

The board of directors of a corporate enterprise with the shareholdings widely scattered have three points to weigh in the matter of dividends:

1. Shall dividends be declared?
2. If so, at what rate?
3. In what medium shall dividends be paid?

It would be unsafe to lay down any hard and fast rules as solutions to the above problems but a brief analysis of each will bring to light circumstances which affect the expediency of distribution of profits to the stockholders.

When should dividends be declared?—The size of the surplus or the amount of net profits from operation, is the first determining factor in dividend policy from the standpoint of whether or not dividends shall be distributed to the stockholders. Normally, the surplus should be of sufficient size to permit of its apportionment among all classes of stock, in as much as the owners expect individual participation in earnings, and any delayed or discriminating distribution is likely to result in unrest among shareholders. We must not lose sight of the fact, however, that the directors are the sole judges of the wisdom or unwisdom of the policies determined upon. Even assuming a surplus large enough to cover a payment upon all classes of stock, the directors may withhold declaration for a number of reasons bearing upon such factors as anticipated expansion, the age of the enterprise, the nature of the product, and general business conditions.

Business units may be expanded by multiplying the stockholding group through further issues of stock, through borrowing by the issuance of additional bonds, or by the reinvestment of surplus earnings. If the directors determine upon the latter policy of expansion it goes without saying that dividend declaration will be passed over, excepting in cases where the earnings have been extremely large. The same may be said for young concerns where dividends are either not available on account of meager earnings or it is desired to build up a surplus for the purpose of insuring greater future stability.

The nature of the product in its relation to the business cycle cannot be overlooked by the directors in determining dividend policy. This consideration revolves around the problems of speculative as opposed to stable enterprise, as well as the production of luxuries or necessary commodities. We may consider, for illustration, a conservative organization manufacturing luxuries placed

beside one producing necessary consumer goods, in relation to the peaks and depressions of the business cycle. When times are good it is probable that consumers divide their expenditures rather liberally between luxuries and necessities. But in depression periods the producers of luxuries are the first to feel the effect of lessened business activity and must govern all of their business policies, including dividend distribution, accordingly.

A further illustration is afforded by concerns manufacturing capital goods, such as machinery for factory production or rolling stock for railroads, which are purchased during periods of industrial activity and expansion, but whose demand falls off in periods of reduced activity or actual depression. The decision as to dividends must be materially affected by these considerations.

What portion of profits should be distributed?—It is not necessary that the entire amount of surplus profits be turned back to the owners. When preferred stock has a preference as to dividends, which is usually the case, it is entitled to its rate as provided in the charter, before any may be received by common shareholders. The latter class of stock may be treated in any manner decided upon by the directors, consistent with charter provisions. In no case, however, are the directors compelled to recognize either or any class as entitled to share in profits.

The relative portions of surplus profits retained and distributed are essentially dependent upon the margin of safety which the directors wish to establish in connection with their financial policies. Certain "contingencies" must be provided for, as no enterprise, however sound, can wholly escape the effects of peaks and depressions of the business cycle. As a result, the by-laws either give the directors the power to reserve certain portions of dividends or make such reserves mandatory. The nature of these reserves was suggested in the second paragraph of this chapter. No dividend rate should be established which cannot reasonably be maintained. For this reason, some boards of directors, wishing to distribute larger

dividends in more profitable years, declare extra or special dividends to avoid modification of the established rate.

It is not an uncommon practice for the charter or by-laws to require the directors to set aside portions of the income for reserves to take care of things which are certain to transpire, such as necessity for liquidation of bond issues, depreciation, obsolescence, and "lean years." Occasionally, lean years are taken care of through dividend equalization reserves, from which dividends may be drawn even in periods where earnings are reduced or even non-existent. Prior to the Great War, business activities were at a low ebb, but were lifted suddenly to renewed prosperity as a result of war conditions, only to be dropped again into comparative inactivity. Subsequent to the war period enormous annual surpluses were changed to tragic deficits within a short period of time. Even in normal times this fluctuation is going on constantly, to the discomfiture of directors, and will continue to do so until business heads have devised some means of combatting the inevitable business cycle.

Where stock is widely held by individuals who depend upon the receipt of dividends for meeting the needs of daily life, any curtailing of their income is accompanied by hardship. For this reason regularity of rate and regularity of payment are essential to the welfare of great numbers of stockholders. Dividend reserves for lean years and extra or special dividends sometimes called "melons," are devices used to obviate the evil results of fluctuation.

Obviously, promoters cannot accurately anticipate earnings when designing the business structure, nor can directors anticipate earnings, business needs, and business conditions for long future periods. Conservatism is therefore a valuable attribute, but a factor often sacrificed in the desire to enhance the market for securities or to make a good showing for general business purposes. These observations are less applicable in the case of small close corporations where the directors are also likely to be officers and stockholders, or at least active in

the control of or participation in the affairs of the enterprise.

In what medium shall dividends be distributed?—When money is invested in corporate enterprise the owner rightly expects profits, when distributed, to be in the form of cash. It may be possible, however, that cash is not, at the moment, available or that the directors deem it a wiser policy to retain the cash and to distribute the surplus in some other form. Dividends may be turned back in any one of five forms.

1. Cash.
2. Stock.
3. Bond.
4. Scrip.
5. Property.

Cash dividends.—It may be restated that the normal procedure is to distribute dividends in cash. For the purpose of illustration of what happens when the surplus is divided among shareholders the following balance sheet may be used:

BALANCE SHEET

THE WITMAN ELECTRIC COMPANY, INC.

<i>Assets</i>		<i>Liabilities and Proprietorship</i>	
Cash	\$60,000	Accounts Payable	\$15,000
Accounts Receivable	30,000	Bonds	200,000
Raw Materials	30,000	Capital Stock	
Goods in Process	75,000	Preferred	300,000
Finished Goods	105,000	Common	500,000
Land Buildings	725,000	Reserve (Sinking Fund) ...	10,000
Investments (Securities) ...	50,000	Surplus	60,000
Sinking Fund	10,000		
	<hr/>		<hr/>
	\$1,085,000		\$1,085,000

Let it be assumed that a 6 per cent dividend is paid on each class of stock. The three thousand shares of preferred stock are entitled to \$18,000 of the surplus and the common to \$30,000 leaving a balance in the surplus account of \$12,000. The balance sheet will now appear thus:

BALANCE SHEET

THE WITMAN ELECTRIC COMPANY, INC.

<i>Assets</i>		<i>Liabilities and Proprietorship</i>	
Cash	\$12,000	Accounts Payable	\$15,000
Accounts Receivable	30,000	Bonds	200,000
Raw Materials	30,000	Capital Stock	
Goods in Process	75,000	Preferred	300,000
Finished Goods	105,000	Common	500,000
Land and Buildings	725,000	Reserve (Sinking Fund) ...	10,000
Investments (Securities) ...	50,000	Surplus	12,000
Sinking Fund	10,000		
	<hr/>		<hr/>
	\$1,037,000		\$1,037,000

Had the directors desired to distribute the entire surplus, the common stock would have received an 8.4 per cent dividend, as preferred stock does not, according to the Witman charter, participate in dividends above 6 per cent. In this case the surplus would be reduced to zero and the cash would be entirely exhausted.

Stock dividends.—As previously stated, cash is not always available but the directors desire to give the shareholders some evidence of the enhanced value of their corporate property. This end may be accomplished by the use of the stock dividend, a procedure equivalent to selling new shares to the holders, permitting them to make payment out of their shares of the surplus. As a result of the use of this device the surplus would be reduced by \$48,000 assuming a 6 per cent dividend for each of the two classes of stock and the common stock account on the balance sheet would be increased by \$48,000 assuming a “common” stock dividend. The balance sheet will then appear:

BALANCE SHEET

THE WITMAN ELECTRIC COMPANY, INC.

<i>Assets</i>		<i>Liabilities and Proprietorship</i>	
Cash	\$60,000	Accounts Payable	\$15,000
Accounts Receivable	30,000	Bonds	200,000
Raw Materials	30,000	Capital Stock	
Goods in Process	75,000	Preferred	300,000
Finished Goods	105,000	Common	548,000
Land and Buildings	725,000	Reserve (Sinking Fund) ...	10,000
Investments (securities).....	50,000	Surplus	12,000
Sinking Fund	10,000		
	<hr/>		<hr/>
	\$1,085,000		\$1,085,000

In the second place, if profits were retained in the business, and no stock were substituted as dividends, the stock already issued would represent continually increasing value of assets and would consequently be quoted on the market at figures materially above par value. The psychological effect of having stock presumably worth \$100 per share quoted at \$150 or \$200 results in reducing the marketability of the shares. Two shares, each having a par value of \$100 and quoted at \$100 each, afford greater marketability than one share having par value of \$100 and being quoted at \$200.

Public utilities have sometimes used stock dividends to increase their capitalization in order to reduce the *rate* of dividend where profits have been large. Obviously, a 6 per cent rate of dividend on \$2,000,000 capitalization *appears* to be a smaller return than does a 12 per cent dividend on a \$1,000,000 capitalization.

Stock dividends have been frequently employed, too, to adjust corporate interests to federal tax programs, especially during the period immediately subsequent to the World War. As Gerstenberg has put it "the income tax on corporations under the law . . . amounted to 12½ per cent, whereas the sum of the normal and the surtax on the income of individuals ran as high as 46 per cent and exceeded 12½ per cent in every case where the income was more than \$51,347.83. The drafters of the law, therefore, anticipated that a number of people, in order to avoid the high surtaxes, would turn over all their income-producing property, whether simple investments or operating property, to a corporation, permit the income to remain in the corporation, and thus pay only 12½ per cent. To meet this possible evasion, the law provided that the Commissioner of Internal Revenue (might) tax at the rate of 50 per cent the net income of any corporation that persisted in accumulating an unnecessary surplus."¹ This surplus tax was later eliminated.

To evade this surplus tax and to maintain whatever advantage incorporation afforded, many corporations re-

¹ C. W. Gerstenberg, "Financial Organization and Management of Business" (Prentice-Hall, Inc., New York), p. 495.

sorted to the device of distributing dividends in stock, such dividends having been previously declared exempt from taxation by the United States Supreme Court, since they represent a mere additional investment on the part of the shareholder and do not represent anything that was not already his. While the relative virtues and evils of the practice of issuing stock dividends in lieu of cash are not clearly established, it may be said that so long as dangerous overcapitalization does not result, or it is certain that future earnings will be adequate to continue the usual rate of dividend as well as a similar dividend on the new stock issued as dividends, and no wrongful manipulation is indulged in, little may be offered in opposition to such a policy.

Bonds, scrip, and property dividends.—The surplus earnings may be retained in the business for productive employment by the distribution of dividends through three other devices—bonds, scrip, and property dividends.

Bonds may be issued in place of cash or stock, a procedure equivalent to borrowing from the stockholders an amount equal to the portion of the surplus to be distributed. In this case the bond account on the balance sheet would be increased and the surplus reduced by an equal amount.

Scrip dividends, used for a similar purpose, are merely paper promises of future payment, which may or may not bear interest or which may or may not have a definite date of maturity, thus being redeemable either within a specified time or merely at the option of the corporations. For example, a corporation might find itself with an adequate profit record, but the profits at a given time might be tied up in accounts receivable, or even in asset values, making it necessary to resort to the temporary device of scrip dividends, thus maintaining a favorable dividend record. Similarly, it may be used in the payment of cumulative dividends on preferred stock in order to resume regular dividends on all classes, the scrip to be redeemed at such time as the company finds itself in possession of sufficient available cash.

By the issue of scrip dividends, the balance sheet sur-

plus would again be reduced by the amount of the dividend and a scrip account of the same amount entered on the liability side.

After the war, some corporations which had invested heavily in Liberty Bonds distributed these as dividends instead of cash. This is known as property dividend and reduces the assets listed on the balance sheet as "investments" in the amount of the dividend, and again decreases the surplus by a similar amount.

Procedure in declaring dividends.—After determining upon the policy of dividend distribution at the directors' meeting, a formal resolution is passed fixing the amount, method, and date of payment. The amount may be stated in terms of a percentage or in terms of dollars per share, and is payable only to stockholders of record. To determine the owners of record, the transfer record books are closed for a certain number of days prior to payment, while the secretary and treasurer are making up the lists and dividend checks. The treasurer is authorized by the resolution to give notice to stockholders of record that the dividend has been declared, stating the date of payment. In small corporations notice is usually sent by mail, but in large corporations it may be published in newspapers. On the date specified in the resolution and notice the dividend checks are forwarded to stockholders entitled to receive them.

Illegal dividends.—Dividends are sometimes illegally declared, and in this event, may be stopped when stockholders or creditors interested take the proper action. Illegal dividends are those which, when declared, impair the capital stock; are unequal as among stockholders of the same class of stock; or are in violation of the provisions contained in statutes, charter, or by-laws. In general, the directors are held liable for the issuance of illegal dividends, the nature and amount of the liability varying among different states.

It has already been shown that preferred stock frequently is given the right of cumulative preferred dividends over common shares. Should the directors attempt to resume the payment of dividends to the common shares

before satisfying the dividends accumulated on the preferred shares, the dividend would be declared illegal, necessitating an adjustment of the dividend declaration.

Where special charter or by-law provisions require that certain portions of the surplus be reserved for specified purposes, such as depreciation, dividend equalization, or other contingency, the dividend declared in violation of the requirements will be set aside by the courts.

It is apparent that the dividend policy determined upon by the directors must be the result of careful investigation of the financial condition of the corporation, and can be arrived at only after consideration of numerous factors. With the exception of illegal dividends, when the declaration has been made public it cannot be revoked, and in case the dividend is not distributed, the stockholders take their place as creditors of the corporation, and as such occupy a more favorable position than they would as stockholders. Where a portion of the surplus has actually been set aside and dedicated to the payment of dividends, the creditors entitled to dividends have a prior claim on the fund over that of the other types of creditors.

Problems.

1. Following is the balance sheet of the Artificial Honeycomb Corporation:

<i>Assets</i>		<i>Liabilities, etc.</i>	
Land and Buildings	\$400,000	Bonds	\$100,000
Raw Materials	100,000	Accounts Payable	50,000
Goods in Process	150,000	Common Stock	670,000
Finished Goods	50,000	Surplus	50,000
Liberty Bonds	75,000		
Accounts Receivable	20,000		
Cash	75,000		
	<hr/>		<hr/>
	\$870,000		\$870,000

What factors would govern the directors of the company in the distribution of these surplus profits?

2. If the directors in good faith refuse to distribute these profits to the stockholders who should normally receive them, what action might you, as a stockholder, take to force distribution?

3. Draw up revised balance sheets to show the altered condition of the corporation after distribution of each of the following types of dividends:

1. Cash.
 2. Stock.
 3. Property.
 4. Bond.
 5. Scrip.
4. Explain when each medium of dividend is to be used.
 5. When are dividends illegal?
 6. Who is liable for distributing illegal dividends?

CHAPTER XVI

AVOIDANCE OF PARTNERSHIP AND CORPORATE WEAKNESSES

In its effort to obviate the insufficiency of the partnership form of enterprise the corporate form has been only partially successful, for in itself it embraces many unsatisfactory characteristics which have already been discovered. Its complicated structure and control, its wide diffusion of ownership, its burdensome fees, taxes, and reports, and severe government restriction have left much to be desired, especially in the case of smaller groups, or groups desiring to gain certain ends. A number of types of enterprise ranging between the pure partnership and the pure corporation have grown out of the desire to secure more fitting tools with which to work. Reference is here made to :

1. The Close Corporation.
2. The Partnership Association.
3. The Joint Stock Company.
4. The Massachusetts Trust.

Structure of the Close Corporation.

The close corporation arises out of a desire to restrict stock ownership in any corporation to a few chosen individuals. Frequently this desire comes about through the incorporation of a partnership in order to take advantage of the corporate form, while still maintaining the previous relationship as partners. In other cases close corporations are created out of "whole cloth," in which case the problems of incorporation are simpler, the main problem being the agreement to restrict the free transfer of shares of ownership.

Incorporating the partnership.—The problems incident to incorporating all enterprises are similar, but when a change is made from the partnership form to the close corporation new problems arise which merit some attention. These problems have to do with:

1. The corporate name.
2. The capitalization plan.
3. Corporate control.
4. Restriction of freedom of transfer.

The corporate name.—In choosing the name for a newly incorporated partnership it is usually advisable to maintain, as nearly as possible, the name under which the partnership has been doing business. Where the state law requires some indication of the corporate enterprise in the name, the old name would be modified with as little change as possible. This practice is especially useful in cases where large “good-will” value has been built up around the partnership name. The usual legal regulations concerning the name were discussed in a previous chapter.

The capitalization plan.—In Chapter VIII will be found a general discussion of capitalization problems. Additional complications arise out of partnership incorporation. For the purpose of illustration, let it be supposed that Smith, Brown, and Jones, partners, desire to incorporate. The value of their assets is \$240,000, each having contributed one third of the capital, and each having equal control. For the sake of simplicity we may assume that they propose to capitalize at real value with one class of stock. A simple corporation balance sheet would now stand as follows:

<i>Assets</i>	<i>Liabilities, etc.</i>
Property, etc.\$240,000	Smith, stock\$80,000
	Brown, stock 80,000
	Jones, stock 80,000
\$240,000	\$240,000

In such a simple case as this, little difficulty would be experienced. But complications arise when, as is fre-

quently the case, one or more partners have invested capital but relinquished control to other partners; or when certain members have invested more capital than others, or have been given more control or a larger share in profits due to larger contribution of time or talent. These adjustments are usually accomplished by stock classification and bond issues. The interest of a silent partner may thus be maintained by issuing preferred non-voting shares or bonds bearing interest equivalent to the share which such partner has been receiving. Similar adjustments would be made to satisfy other requirements.

“If the partners take the amount of stock in the new corporation to which their respective partnership interests entitle them, and let the selection of the board take its natural course thereafter, the matter is simple. Usually, however, the partners wish an equality of power in the board, or a specified representation, or a classification, or some other special arrangement, and the composition and method of electing the board of directors frequently becomes the most difficult question arising in the incorporation of a partnership.

“Where equality of power is desired, each partner will usually designate one or more directors, so that the completed board will contain an equal number of representatives for each partner. Where the partnership consists of three or more, the usual practice is to make the number of directors equal to the number of partners, elect all the partners, or the chosen representatives of any partners not wishing to appear on the board, and then make provision for the maintenance of the board so constituted.

“Where there are two partners, the matter is less easily arranged. Three is the minimum number of directors usually allowed, and the necessity of having a third director who really has the deciding vote in any point of difference makes the situation difficult. Sometimes a confidential clerk, or a mutual friend, or the wife of one of the partners is chosen, but in event of any difference the result is apt to be very unsatisfactory. If possible, a mutual friend of character and standing may be elected,

with the understanding that he is not to be involved or troubled in any way unless serious differences arise, when he will virtually act as an arbitrator. Another plan is to have some indifferent person accept the office and immediately resign, leaving the third position vacant with the two partners in control to fight out the differences just as they would have done in the days of the partnership. If this plan were objectionable on account of the incomplete condition, the membership of the directorate might be fixed at four, each partner being elected to the board and designating an additional member. In such case it may be wise to provide for arbitration in case of a deadlock.”¹

In order to maintain the control or management features existing in the partnership, those partners who have taken no active part in the management, may be given non-voting stock or bonds, while those having the entire management under the partnership form will be given the voting stock representing their interests in the old organization. It is possible, thus, to continue the relations of the partnership enterprise while securing, at the same time, whatever advantages attach to incorporation.

How is the close corporation maintained?—Too great restriction on the freedom of transfer of corporate shares is undesirable. But only by some means of restriction can the close-corporation relationship be continued. It is usual to provide in the charter that, before he sells his interest to an outsider, a stockholder must offer it to the corporation at a reasonable price. If they refuse to purchase, he becomes free to sell elsewhere and thus break up the old relations. Any more rigid charter provision, or any provision contained in any other document than the charter, may find enforcement impossible. A sample agreement of the approved sort is reproduced on page 140.

The same may be said of cases where each party agrees to give an option to the other parties running for a specified period. Any by-law provision prohibiting alienation of stock is illegal as contrary to public policy.

¹ Conyngton, “Corporation Procedure,” page 504.

The Partnership Association.

For the purpose of establishing perpetuity and limited liability not found in the partnership, Pennsylvania and Michigan have passed laws permitting the creation of limited partnership associations, having transferable shares, a mechanism for control similar to the corporation and one involving directors and officers. Like the corporation, its organization is accomplished by a certificate, filed with the secretary of state and in the proper county office, accompanied by the proper fees.

The shares of ownership may be freely transferred, as in the corporation, with the exception that the transferee or purchaser must be acceptable to the other members, and admitted only by their favorable vote. In case their membership is not favorably acted upon, the remaining partners are compelled to purchase the interest of the rejected member at a price acceptable to both parties, or in case of dispute at a price set by court ruling.

One reason why this form of organization is not more widely used is the uncertainty of its treatment by other states in case the business is interstate in scope. In general, it may be said that it is interpreted as being an ordinary partnership having the unlimited liability feature instead of the limited liability granted in the state of creation. Any use for interstate business is thus prohibited.

A second reason for its infrequent use lies in the fact that it has little advantage over the corporate form and lacks the advantage of interstate recognition and consequently gives way to the corporate form.

The Joint Stock Company.

Like the partnership association, the joint stock company is similar, in some ways, to the partnership, and in others, to the corporation. Its creation is probably permissible under the common law although the states have quite generally passed statutes for its organization and control.

This association, formed by an agreement similar to the one used in creating general partnerships, is like the

corporation and partnership association in that it has transferable shares, but resembles the partnership in that these shares are accompanied by unlimited liability of the owners. The organization cannot hold real estate in its own name but can hold it in the name of its president. In this instance, it is like neither the partnership, which holds property only in the names of the partners, nor the corporation, where ownership is placed in the organization as a legal entity without reference to its membership or officers. Whereas a partnership must sue or be sued in the names of the partners, and the corporation in its own name, suit in New York is instituted by or directed against the president or treasurer of the joint stock company. In most other states the joint stock company resembles the partnership in this respect.

Perpetuity of existence is insured to this form of enterprise by virtue of the fact that shares are truly transferable and withdrawal of a partner by sale of his interest, or for other reasons, does not dissolve the organization. As a part of this feature, management is placed in the hands of a board of directors, who elect officers in much the same way that corporate directors and officers are selected. Such an arrangement eliminates the danger inherent in the partnership form, where each partner may act as agent for all other partners and bind them to contracts without their permission, by providing an official agent who alone may bind the other members, who nevertheless retain their unlimited liability for contracts made by their appointed agent.

The advantages accruing to the joint stock company over the general partnership lie in the realization of perpetuity through transferability of shares accomplished without the fees and taxes exacted when the same end is attained by incorporation.

In New York the joint stock company is required to file a certificate of organization showing the personnel of its officers together with their addresses.

This type of enterprise is little used in the United States because of its failure to attract investors, due to the unlimited liability feature. The lack of legal entity

prohibited the holding of real estate in the association name and the variation in state provisions as to suing and being sued, result in technicalities which limit the possibility of wider use.

The Massachusetts Trust.

This form of enterprise is the outgrowth of a statutory prohibition, in Massachusetts, against the organization of corporations having as their purpose dealing in real estate, the prohibition being based on the fear that the unlimited duration of corporations held the possibility that they might, through the medium of large land holdings, become more powerful than the state. Although the prohibition was lifted in 1912, the so-called Massachusetts Trust still forms an important local type of enterprise.

In an effort to gain as many as possible of the corporate advantages, land holding groups seized upon the universally used trust principal which formed a more or less convenient and effective vehicle by which to carry out the desired program.

How the Massachusetts trust is created.—The Massachusetts trust is created through the drafting and execution of a deed of trust, which is merely a contract between the trustee and one or more persons acting as beneficiaries and who, for this purpose, represent not only themselves but such other persons as may thereafter, and from time to time, become interested in the trust, either by investing money in the trust, or by buying out, or in some other way receiving, another beneficiary's interest in it. These interests in the trust are represented by certificates, frequently called certificates of stock, which in outward appearance simulate as far as possible the certificates of stock of a corporation. They may be listed and dealt in on the various stock exchanges. It is not uncommon for a trust to have several classes of common and preferred shares, and it is possible to have any division of income, risk, and control among the shareholders that may seem desirable. The trustees are

not unlike directors of a corporation, who manage the property for the stockholders; the *cestuis que trustent*, or certificate holders of the trust, correspond to the stockholders in a corporation. The deed or declaration of trust, which is drawn up, describes the business of the association and the duties, rights, and liabilities of the trustees and shareholders. The deed usually provides that the trustees shall appoint and remove a president, vice-president, and other officers, agents, and employees actively to carry on the business of the trust. The trustees need not conduct the business in their own names; they may adopt a name for business purposes, as, for example, the Massachusetts Electric Companies. In fact it is the general practice to specify a name in the deed of trust. Moreover, they usually have a common seal, not unlike the seal of a corporation. Dividends are distributed by the trustees out of profits as determined by the deed of trust. As a rule, the indenture gives the trustees wide discretion in the matter of declaring dividends. A common provision governing dividends is that the trustees may from time to time declare and pay dividends from the net income of the trust fund among the *cestuis que trustent*; and their decision as to the amount of dividends, and as to the use therefore of any portion of the surplus fund, shall be final. They may set aside from time to time such portion of the net income as shall not be required for dividends for a surplus fund. Their decision as to what is income and what is capital shall be final. This provision gives the trustees authority over dividends similar to that possessed by corporation directors.

Availability of the Massachusetts trust.—It may be of interest to compare the Massachusetts trust with other forms of enterprise considered thus far from the stand-points of:

1. Control.
2. Risk.
3. Dilution of profits.
4. Degree of government control exercised.

Control or management.—It has already been observed that the Massachusetts trust is, structurally, similar to the corporation although the method of creating the organization is different. The contractual relationship in the trust is established between the stockholders and the trustees, and in the corporation, between the state and the corporation, without reference to the members. The functioning of the two types is also similar, but some differences should be considered.

In a corporation, the management is subject to frequent change. Usually new directors must be elected each year. It is very frequently desirable, and in many cases essential, that the same management remain in control. For example, a minority interest may demand for their own protection that half of the board of directors be designated by them. This is partially accomplished in a corporation through a voting trust, which will be discussed later. But a voting trust is legal only for a limited period of time—in New York, ten years, and in Maryland, five years, and in other states, a reasonable period. In the case of the Massachusetts trust, however, the management may be permanent. If the stockholders of a Massachusetts trust wish to escape the liability of partners, they must exercise no control, and they cannot, therefore, be given the power to elect the trustees periodically. Provision may be made, if desirable, for the selection of a new trustee by the certificate holders or by a class of them, in case of the death, withdrawal, or removal of a trustee. By classifying the trustees and by providing that a vacancy in a certain class of trustees shall be filled by the corresponding class of stockholders, the minority may be assured of permanent representation.

Degree of risk in the Massachusetts trust.—This form of enterprise is made more available by reason of the fact that the liability is placed in the trustees, thus freeing the stockholders from risk much in the same manner that stockholders in a corporation are relieved.

It is well settled that the beneficiaries, that is, the stock-

holders, in the Massachusetts trust are not personally liable for debts contracted or torts committed by the trustees. Creditors can look only to the trustees, or when the trust agreement so provides, only to the property included in the trust. This liability differs from that of the partners of a partnership but is similar to that of the stockholders in a corporation. In common practice it is necessary, though difficult, to distinguish in some instances between this form of trust and a partnership. Stated very briefly, the question becomes: does the trust deed or agreement under which the trust is formed constitute merely a trust deed or does it partake of the nature of a partnership contract?

In Massachusetts, where the law concerning trusts as business associations has been most fully developed, it has been held that the provisions in a trust agreement giving the shareholders power to remove the trustees without assigning any cause, and to appoint others to fill the vacancy, and to amend the declaration of trust, demonstrate that the association is a partnership having unlimited liability for the members. It appears then that if the stockholders have a right to control the trustees by the power to remove and elect them, or to elect them periodically, or if the shareholders have a right to manage the property themselves, the association will be considered a partnership, and the shareholders be held personally liable. On the other hand, if the trustees act as principals and are free from the control of the stockholders, a trust is created and the shareholders have only the right to compel the trustees to render an accounting and to hold them to the consequences of dishonesty or neglect and cause their removal for either of these offenses. This includes the right of each shareholder to receive his share of the income to the trust in accordance with the trust deed and his share of the remaining assets of the trust when it comes to an end.

In any event, even where the trust may be considered a partnership because of the control which the shareholders may exercise over the trustees, the liability of the stockholders may be restricted by including in the

trust deed, and consistently observing, a clause similar to the following:

Neither the trustees nor the beneficiaries (shareholders) shall ever be personally liable hereunder as partners or otherwise, but that for all debts the trustees shall be liable as such to the extent of the trust fund only. In all contracts or instruments creating liability, it shall be expressly stipulated by the trustees that the shareholders shall not be liable.

Anyone dealing with the association, even though it might be otherwise considered as a partnership, who has notice of this provision, has no right of action against either the trustees or shareholders personally. This provision, however, would not relieve the shareholders of personal liability (if the association were held to be a partnership), in case of the commission of a tort by the trustees in managing the property, or if the trustees neglected to notify contract creditors and the latter had no information of the intention to limit liability to the amount of the trust estate. If the association were a pure trust, that is, if the shareholders did not control the trustees through the right of election and removal, then the shareholders would be under no liability in any event, whether a clause limiting the liability of trustees and shareholders were included or not.

Liability of trustees.—It has been shown that usually the stockholders in the Massachusetts trust may be relieved of liability and the risk of losing their private fortunes, by placing these burdens upon the shoulders of the trustees. The question now arises, for what may the trustees be held liable? By way of reply it may be said that a trustee in this form of association has much the same obligations to stockholders as those attaching to the directors of a corporation. It may be said further that in the management of the property held by him in trust the trustee may not be permitted directly or indirectly to derive any personal advantage from its use or sale but must act solely in the interests of those beneficially interested. If he makes any profit he must account for it to the shareholders.

In managing trust property a trustee must use the judgment and care of a reasonably prudent man. If he fails to do so, he is liable for any resulting losses. Usually, however, the trust deed constituting a Massachusetts trust stipulates that the trustee shall be liable only for the result of his own gross or wilful negligence or bad faith. While this provision protects the trustee against loss because of failure to exercise what the law calls the judgment of an ordinarily prudent man it does not protect him if he uses the property of the trust for purposes other than those specified in the trust deed, nor in case where he shows such reckless indifference to the true interests of the trust as to amount to or partake of a wilful violation of duty.

In dealing with outsiders, trustees are personally liable, unless they clearly indicate that they are acting as trustees and that only the trust property is liable. In contracts with third parties trustees usually stipulate that creditors may look only to the funds and property of the trust for all payments and not to the shareholders or trustees personally. This stipulation has been held valid. Further than this, the trust deed usually provides that if the trustee shall ever become personally liable as such, but not due to his acts in bad faith, he may be indemnified out of the trust property.

Dilution of profits.—The problem of sharing profits in the Massachusetts trust organization is identical with that found in the corporation and consequently needs no further discussion.

Government regulation of Massachusetts trusts.—Up to the present time only a few of the states have attempted to regulate these trusts. In Massachusetts the instrument or declaration of trust must be filed with the commissioner of corporation and with the clerk of every city or town in which the association does business. The filing fees are nominal, and not nearly as large as the combined organization tax and filing fees paid by corporations. In 1916 Massachusetts also imposed an annual tax on dividends or shares in these associations. Other states have extended the franchise taxes normally

charged to corporations for doing business as such so as to include the privilege of doing business as Massachusetts trusts.

Outside of Massachusetts, trusts need not pay any organization fees. It is customary, however, to file the trust deed in a public office and to pay the filing fees, which are merely nominal. They are not required to file annual state reports, nor, in most states, must they pay any annual franchise taxes.

In some states the amount of preferred stock and bonds which a corporation may issue is limited to a portion of its common stock. The trust, however, labors under no such restriction. It is free to have as many classes of shares as it wishes; it may have any amount of preferred stock and any amount of bonds. In fact, its whole form of organization is much more flexible than the corporation, the range of possibilities of form and organization being limited only by the desire and imagination of the organizers. It may have any number of trustees (most states require corporations to have three or more directors); the trustees need not be residents of the state of formation; and their meetings may be held in any state. Usually the state statutes require one or more resident directors of a corporation and require their meetings to be held within the state of incorporation.

For reasons that need not be considered here the laws of most states will not permit such a contract to be made for an unlimited time. In New York state and many other states the time cannot be longer than twenty-one years and nine months after the death of one or two persons named at the time the contract is made. To be sure, where a trust is limited in this way and the period expires the parties interested at that time can agree to another trust running for another maximum period.

In many states corporations are forbidden to engage in certain activities. In a few states, for example, corporations may not deal in real estate, while in some they may not hold stock in other corporations. On the other hand, a trust may, like the individual or partnership, engage in any form of business. The only limitation is

that prescribed by the deed of trust, which the organizers themselves are free to prepare. Even where holding companies in corporate form are permitted, they are frequently subject to vigorous state regulation, particularly when the corporation is one which holds public utility securities. Trusts are free from such regulation; the inclination of state legislatures to regulate more severely public utility holding corporations will undoubtedly encourage the growth of trusts for this purpose. Another advantage of the trust is that it may do business in any state without any formalities. This right is guaranteed by the Constitution, which provides (Art. IV, Sec. 2) that "the Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States." Corporations, however, are not citizens within the meaning of this clause of the Constitution. They must invariably file certificates and pay franchise taxes and submit to regulation in each state in which they do business.

Compensation of trustees.—While in most states a director of a corporation is not entitled to any compensation unless the certificate of incorporation or the by-laws so provide, or unless the stockholders consent, trustees in a business trust are entitled to reasonable compensation for their services, unless there is a contrary provision in the deed of trust. Usually the trust instrument specifies what the compensation shall be.

Advantages of the Massachusetts trust.—The trust has most of the advantages of the corporation. Moreover, it has greater flexibility, greater economy and is, therefore, more convenient than the corporation. Boards of directors of a corporation must necessarily act more slowly than the trustees of a Massachusetts trust and with less ease. The trust is especially adaptable for amassing capital to be used in developing and improving real estate as continuity of management and control are insured. Owing to the fact that in the corporate form some of the directors are changed annually, this continuity cannot be obtained under such form.

Unless legislatures regulate the associations formed

under deeds of trust in much the same way as they have regulated corporations, we may expect the formation of an increasingly large number of these voluntary associations for the conduct of business enterprises. As the voluntary association does not obtain a franchise or privilege of doing business from the state (such as the corporation must obtain) it will be much more difficult, if not impossible, for legislatures to regulate and tax trusts to the same extent as they do corporations.

Disadvantages of the trust.—"It must not be thought, however, that the trust is an ideal form of organization. The great difficulty of the trust lies in the fact that the relationships which it creates are governed by the precedents of courts which are not uniform throughout the English-speaking jurisdictions. In fact, in many questions of jurisdiction may arise that are entirely novel; what disposition the courts would make in an actual case brought before them is in doubt. Uncertainty of this kind 'puzzles the will,

And makes us rather bear those ills we have
Than fly to others that we know not of;'

Such uncertainty is so inimical to honest administration that many lawyers advise strongly in favor of the corporation. Taxes are less burdensome than confusion."¹

Problems.

1. What is the purpose of each of the types of enterprise considered in this chapter?

2. What is the function of the close corporation?

3. *A, B, X, Y, and Z* are in partnership. *A* and *B* invested \$25,000 each and *X, Y, and Z* each invested \$50,000. *A* and *Z* have been participating only in profits and have had nothing to do with the management. Show how this relationship might be maintained if the corporation is changed into a close corporation.

4. What advantages would the new corporation have?

5. How can this relationship be maintained?

¹ Gerstenberg, "Financial Organization and Management," Ch. V., pp. 64, 65.

6. What is to be gained by organizing as:
 1. A partnership association?
 2. A joint stock company?
 3. A Massachusetts trust?
7. Why have these forms not been more widely used in the United States?

CHAPTER XVII

PROTECTION OF SPECIAL GROUPS

A minority partner in a partnership may exercise considerable influence upon the majority partners by the threat to dissolve the partnership by withdrawal, but the minority stockholder has little defense save as protective devices are created by statute, charter or by-laws. Before making an analysis of the devices which may be employed for protection of minority stockholders it may be beneficial to inquire into the causes of the presence of minority groups. Two illustrations will suffice. Ordinarily incorporators retain a controlling portion of the voting stock, permitting the remainder to be scattered more or less widely among the stockholders who wish to become members of the association. Clearly if the minority is widely scattered, and consequently rarely represented in numbers approaching the entire minority, a relatively small number of shares, when concentrated, constitute a majority. A similar majority may be created when a small group is able to purchase a controlling interest in the open market.

Originally, under the common law, the minority stockholders had only the individual rights attaching to all stock—participation in stockholders' meetings, inspection of the corporate stock records and, within reason, the financial account books, large voting majority requirements in the case of action upon certain questions such as charter amendment, selling the entire corporate assets—some of which enabled the minority to exert some pressure, but which generally left the virtual control in the hands of the majority group.

What little possibility of exerting pressure the individual stockholder had originally has been further re-

stricted by statute law, and the increasing size and use of corporate enterprise and the diffusion of stock ownership over wide areas have contributed to the problem of maintaining individual or minority representation in control. By way of illustration, reference may be made to the policy of a number of leading incorporating states in which free inspection of the corporate books has been largely restricted by statute law, as is the case in New Jersey, where corporations are permitted to introduce charter or by-law provision granting the directors the power to define the rights in this respect.

However, it is not uncommon to find statute provisions designated to protect the individual or minority group by making it possible for the charter to stipulate rights that would not normally be credited to stockholders, or even making such provisions mandatory upon the corporation. Cumulative voting, limitation upon directors in the matter of indebtedness, and so forth, are cases in point. The rather detailed analysis of the corporate form of enterprise which has been presented, now places us in a position to make inquiry into the nature of protective provisions more effectively.

Typical provisions are:

1. Cumulative voting.
2. Classification of stock.
3. Audits.
4. Limitations on directors.
5. Large voting majorities.
6. Proportional voting rights.

Cumulative Voting.

Cumulative voting, referred to briefly elsewhere, permits the minority to have at least minority representation on the board of directors. Assume that the incorporators subscribed for 900 voting shares each, or a total of 2,700 voting shares, leaving only 2,300 of the total of 5,000 in other hands. This latter group constitutes what is known as the minority, and may be protected by cumulative voting.

In a meeting of stockholders in which Witman, Meyer, and Thompson, the incorporators, are running for the directorship, they may, according to the charter provision, which does not contain the cumulative voting feature, vote 2,700 times for themselves and the best the minority may do would be to vote 2,300 times for each of three other candidates, X, Y, and Z. But under cumulative voting the minority might, instead of voting 2,300 times for each of *three* candidates, cast three times 2,300 votes for *one* candidate, say X. The result would now stand:

X	6,900 votes
Witman	2,700 votes
Meyer	2,700 votes
Thompson	2,700 votes

Obviously, X cannot be defeated. For the majority cannot cumulate its votes for Witman and Meyer without alienating them from Thompson. Following is a formula for determining the smallest minority which can elect one or more directors, and the solution of an additional problem using the formula should serve to clear up the device of cumulative voting. The formula suggested is:

$$1 + \frac{ac}{b + 1} = x.$$

In this formula, a indicates the total number of issued voting shares; c , the number of directors the minority desires to elect; b , the total number of directors to be elected; and x , the smallest minority which may elect the desired number of directors.

Now it may be proved that fewer than 2,300 minority shares could have elected X over Witman, Meyer, or Thompson. Applying the above formula to determine the smallest minority who could elect X, we have:

$$\frac{5,000 \times 1}{3 + 1} = 1,250 \text{ shares.}$$

Instead of requiring a minority of 2,300 shares to elect X, a group of 1,251 shares could have accomplished the

feat under cumulative voting. This solution assumes that the entire number of majority shares will be represented in opposition to the 1,250 shares held by the minority. In a large corporation it is a safe assumption that the majority will not be represented in its entirety so that a smaller minority than the one arrived at by solving the formula could secure representation on the board of directors.

Advantages to minority.—The question may arise as to what advantage accrues to a minority group of stockholders from having one director on the board, for with only one-third of the total vote he could count for little in deciding questions of policy. However, his presence would act as a check on the conduct of the majority representatives and he might act as informant to the group which otherwise would not have access to so complete a report from activities of the directing group.

Classification of Shares.

The by-laws may provide for stock of different classes, adjusting the voting rights in such manner as to provide some little voice for minorities in policy determination. Each class of stock carries the right to elect a certain number of directors, insuring some degree of representation.

Auditing of Books.

Both the minority and majority groups of stockholders may be protected to some extent by periodic audits of the corporation's financial records. Due to the fact that the conduct of corporate affairs is entrusted to a small centralized controlling board and nearly all power of determining policies is relinquished by the owners, it follows that some device is necessary to permit of obtaining information which might not otherwise be available. Such a device is, obviously, of especial value to the minority group, particularly when it has no possibility of securing representation on the board of directors, through cumulative voting or classification of stock.

Limitations on Directors.

In discussing special provisions which might be placed in the charter of the corporation, affecting the activities of the directors, reference was made in Chapter X to certain limitations on the directing group whereby the stockholders, especially the minority group, are protected against unwise or unfavorable disposition of the corporate funds. It will be recalled that these limitations take the form of prohibition against excessive debt contracts and salary awards to officers of the corporation. These represent typical limitations which may be included, but by no means exhaust the possibilities of further protection to special groups through restrictions placed upon directors in their control of corporate policies. The reader should examine the charters and by-laws of specific enterprises for additional illustrations.

Large Voting Majorities.

Additional protection may be acquired through special charter or by-law provisions requiring that all or certain policies over which the directors have jurisdiction be carried only by large majority votes of the board or even by unanimous action. This device may or may not be of value to the minority, but in cases where cumulative voting is permitted, resulting in one or more minority representatives sitting on the board, it would seem to contribute some advantage.

To illustrate, reference may be made to one by-law provision requiring that no directors may be elected excepting by a large majority vote, thus giving the minority great advantage. If the majority is required to be a seven-eighths vote to elect directors, modify the charter in some way, or increase the capitalization, it is obvious that a minority consisting of one quarter (two eighths) of the stockholders can defeat the majority policies, thus forcing majority recognition.

Proportional Voting Rights.

Where majorities might be created through the purchase of stock on the open market it might be provided

in the charter, if permitted by statute, that each additional increment of stock obtained might, after a certain point is reached, carry a decreasing proportion of voting rights. Suppose, by way of example, that an individual desires to gain a controlling majority of voting stock. A charter provision might be inserted to the effect that each share carries one vote until 100 shares are secured. Each additional 100 shares entitles the purchaser to only 10 votes for each 20 shares, and so on. The point may be reached where any additional increment adds no further voting right. It is thus made impossible for control to be concentrated in the hands of an individual or a small group of individuals.

Protective Committees.

The formation of stockholders' committees to check up and advise in the policies of corporation management from the point of view of the small shareholder has been proposed by Prof. William Z. Ripley, noted Harvard University economist.¹

He offers this as a solution to the situation he has pointed out in previous articles in which he has shown how most of the small buyers of securities are largely shut off from participation in management or even from accurate, adequate information as to the corporation's financial standing.

Noting how committees of stockholders or bondholders almost automatically form themselves in times of emergency in a company's affairs, Professor Ripley advises that committees of this sort should be active during a corporation's years of prosperity, as well as in temporary adversities. He takes cognizance, however, of the objection that the average stockholder is entirely unqualified to engage actively in management. The problem, therefore, is to devise something within the range of shareholders' probable capacity which shall point toward, even if it does not attain, the desired end of a reasonable check and balance upon management. Such a body,

¹ *World's Work*, December, 1926, pp. 128-138.

either created out of hand or else evolved from the present board of directors, might be expressly empowered in the charter to assume certain responsibilities and to perform certain functions by way of check-up, so to speak. The primary function would have to do with adequate publicity through independent audit. The purpose of such a continuing body would not be to fight management, but to watch it and consult with it prior to any important action. "Only by having some voice in the handling of their material possessions," insists Professor Ripley, "will it be possible for people to perpetuate a civilization founded upon the institution of private property."

The Voting Trust.

"A method, known as a voting trust, for concentrating the control of a company in the hands of a few people has been devised. A trustee, or a group of trustees, makes a contract with the stockholders providing that any of the stockholders of the company may deposit their stock and become parties to the agreement. Since their stock is transferred on the books of the company to the voting trustees, the latter become the real stockholders and, during the period of the agreement, vote at the annual elections and at special meetings. Voting trust certificates are given to the stockholders who become entitled to the dividends. The certificates are often listed on the exchanges. When the trust is dissolved the trustees exchange their stock for the certificates of beneficial interest and the stockholders thereupon become reinstated with the right of control.

"Voting trusts cannot be used in a number of competing corporations to work out a monopoly. This doctrine was decided many years ago when monopolies were organized through the formation of a voting trust to take over the legal title to the stock of the several corporations that entered the old Standard Oil trust and the old sugar trust. In fact, it was in connection with these voting trusts that the work 'trust' first came to be applied to monopolies. Usually a voting trust must be lim-

ited in time, measured by the definite purpose to be accomplished. For example, if the bondholders of a corporation threaten to foreclose the mortgage securing their bonds, they may be induced to forego this right by being given control of the corporation till their bonds are paid off. This can be done by creating a voting trust in which the trustees are nominated by the bondholders. In this way the bondholders would control the directorate of the company until their bonds had been paid off. In New York state, under the statutes, a voting trust cannot endure for longer than ten years.”²

“Voting trust agreements assume various forms. Such agreements may be made in respect to stock already owned, or in contemplation of the acquisition of stock of a corporation *in esse* or of one about to be formed. A common form is that of an assignment by a trust agreement, whereby the collective voting power is vested in an appointee by a majority in interest of the stockholders and generally sets forth the objects of the transaction and the authority and obligations of the trustee.

“In the instance of the decree by the United States District Court dissolving the New Haven Railway System, in 1914, a voting trust was created in accordance with the direction of the court.

“The early prejudice against voting trust agreements evidenced in the earlier decisions has gradually given place to a more favorable sentiment based upon the conception that the owner of property may deal with it as he sees fit, providing the use does not exceed the legal limits.

“In some jurisdictions, however, voting trust agreements have been pronounced illegal on broad grounds of public policy, although generally specific objections are referred to or definite infringements indicated.

“The effects of such agreements must be carefully noted to determine whether elements of personal profit

² C. W. Gerstenberg, “Financial Organization and Management of Business,” p. 108.

or fraud, restraints or alienation of trade, and so forth, may be anticipated or may have resulted therefrom.”¹

Problems.

1. Explain each of the following possible protective provisions:

- a. Cumulative voting.
- b. Classification of stock.
- c. Audits.
- d. Limitations on directors.
- e. Large voting majorities.
- f. Proportional voting rights.

2. Would they be better placed in the statutes, charter, or by-laws? Why, in each case?

3. The balance sheet of the Artificial Honeycomb Corporation carries 6,700 voting shares of stock. What is the smallest minority of these shares that can elect one director if there are three to be elected? Two out of five? Prove each conclusion.

4. How many could any minority elect without cumulative voting?

¹ Crow, “Corporation Secretary’s Guide” (Prentice-Hall, Inc., New York), pp. 182-184.

PART II

INTER-RELATIONSHIP TYPES OF ENTERPRISE

CHAPTER XVIII

THE DEVELOPMENT OF "BIG BUSINESS": AGREEMENTS AND POOLS

Business enterprise is naturally monopolistic. One needs only to look about him to verify this conclusion, for even superficial observation discloses the fact that, so far as the United States is concerned at least, the movement toward concentration of capital in productive enterprise is widespread and increasingly predominant. Both the federal and state governments have recognized this tendency by the passage of so-called "anti-trust" laws which have sought to obviate the evils arising out of all "combinations in restraint of trade," regardless of their nature, but which have resulted only in retardation of the birth and growth of a variety of methods by which enterprisers hoped to accommodate themselves to government interference without sacrificing the advantages of inter-relationship. The government has further recognized the inevitable trend by its own encouragement of business and industrial coöperation during and after the war period.

It may be said, then, that while the variety of simple types discussed in Part I grew out of the attempt on the part of individuals to adjust their contractual relationships most advantageously, the variety of "compound types" is due to an effort to adjust the relationships among different units of enterprise with the greatest possible effectiveness and efficiency.

Principles Underlying Concentration.

If we grant the truth of the conclusion that business, as such, inevitably tends toward concentration, there re-

mains the task of seeking and analyzing the factors underlying the tendency. These contributing factors may be listed as:

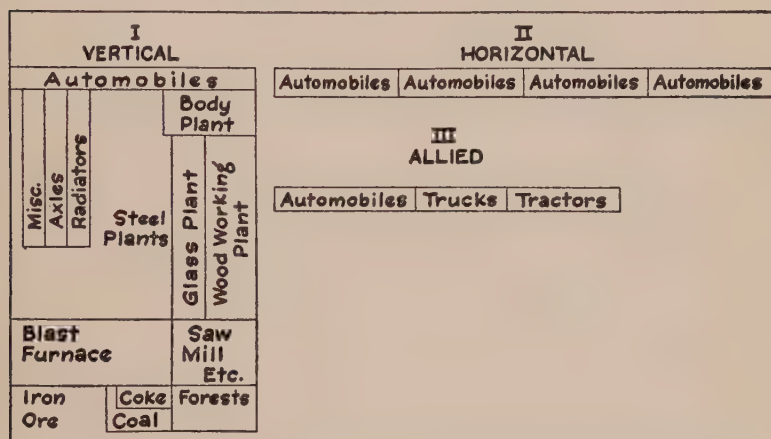
1. The destructive nature of competition.
2. Effectiveness of large scale production.
3. The business cycle.

The destructive nature of competition.—In the past, it has been generally believed that “competition is the life of trade.” This view has been held even in the face of costly lessons learned from the tragic results of unrestrained competition, especially in the transportation industries. While the results have not been so tragic, socially, in the general industrial and commercial fields, the cost incident to maintenance of the competitive theory, may at least be designated as excessive.

The original movement toward concentration owed its inception and impetus to cut-throat competition among industries and commercial enterprise, which had indulged in successive orgies of price cutting in order to attract patronage, until all were on the verge of financial destruction. The only available remedy must be some form of coöperation among producers or merchants, by which prices might be maintained. To gain the advantage of survival for all each must surrender something to the common cause. The result was the pooling agreement, out of which sprang, in clear-cut stages, successive devices designed to gain the same end. These devices will be considered in detail in the subsequent chapters.

Effectiveness of large scale production.—The opinion seems to prevail that large scale production is more efficient than small scale production. If this second assumption be true, the moment large enterprises become established through concentration of large funds of productive capital, the smaller producer can no longer compete successfully and must either go out of business or be absorbed in some way or other with the more advantageously situated competitor. In either case, the cumulative result is the cessation of competition in the particular field in which such conditions exist.

Large scale production may be effected by combining *horizontally* where the units brought into the organization are engaged in producing a single product, such as automobiles, or *vertically* where the units of enterprise each contribute a finished product, which becomes the raw material for the next process until the finished product is completed. The following chart will illustrate the relative structure of three classes of combination:¹



There are certain advantages which should logically develop from large-scale production. The following outline is, in general, a presentation of the various possible economies of producing on a large scale. They represent potentialities and are conditioned by both the type of industry and the nature of management.²

A. Economies in Production.

1. The materials required, as well as fuel or electric power, can usually be obtained more cheaply if purchased in large quantities. In addition, large purchasers secure more ready attention and more careful consideration from the sellers.

¹ Dwight T. Farnham, "The Vertical Trust," *Industrial Management*, May, 1924, p. 258.

² Adapted from "The Integration of Industrial Operation," Census Monographs III., U. S. Dept. of Commerce.

2. The labor force may be more advantageously utilized, since the processes can be divided, resulting in saving due to division and specialization of labor.

3. The plant and equipment may be more advantageously utilized. The demand for products will be more exactly forecast and therefore there need not result slack and rush periods of work. According to figures collected by the National Bureau of Economic Research, however, the large enterprises showed greatest variation in activity from 1919 to 1922.

4. The materials may be more effectively utilized, either by by-product manufacture or by disposing of waste in bulk.

5. Standardization can be more easily applied, resulting in better coördination within the process.

6. Research and development through investigative agencies may be carried on at less cost per unit of output and may result in a saving in the technical processes of the industry.

B. Economies in Marketing.

1. Transportation may be done in greater bulk, resulting in a saving per unit transported.

2. Advertising costs will represent a smaller burden on each unit of output, although the amount of advertising may actually be increased.

3. The selling force required will not increase in the ratio in which the sales increase, therefore resulting in less cost per unit of product.

4. Distributing and selling agencies may be maintained.

5. The value of good will and of trade-marks and designs will increase with the volume of business.

C. Economies in Management.

1. The overhead cost per unit of product, particularly the fixed charges, will not increase proportionately to the production.

2. Better management can be afforded, with skilled heads for the different departments and branches. This

factor is somewhat offset by the greater impersonality of large concerns.

3. Cost accounting, production standards, etc., may be introduced at less cost per unit of product.

D. Economies in Financial Administration.

1. Borrowings can be made at cheaper rates as a result both of larger issues of bonds and of better security.

2. The amount of risk taken will be less because of the pooling of profits and losses, the greater ability to study outside market conditions, and the more able administration.

3. Greater financial resources will be available in case of depression or business strain.

These various potential advantages of large-scale production must be taken into account in explaining the situation in certain industries. Although the manufacturer in all probability expands his business because of pure acquisitiveness, personal pride, or the necessity of investing a surplus, it is nevertheless true that the factors in the above outline are those which, by entering into such a reorganization, insure its life.

The advantages of large-scale production give but one view of the situation. There are certain industries which are more eligible for large enterprises than others. In general, the following types of industry appear to have developed production on a large scale to the greatest degree:

1. Industries which require a large capital investment, particularly in plant and equipment: sugar refining, copper smelting, steel mills.

2. Industries which are monopolies, and which have a sufficiently large market to make operation on a large scale feasible. This includes artificial monopolies, such as those based on patent rights, as well as the monopolies, by nature: public utilities, manufactured ice.

3. Industries in which a natural resource is required and in which that natural resource is limited in amount and localized in geographical distribution: the manufacture of lead and zinc products.

4. Industries in which the product is capable of standardization and particularly in which a test for quality is required: sugar, salt, meat packing, and the like.

5. Industries in which the product is highly complex and can be constructed, therefore, only by an intricate fabricating system or a large and diversified organization: typewriters, adding machines, textile machinery, and automobiles.

6. Industries in which the product is large in size, requiring complex equipment for construction and large capital investments: shipbuilding, locomotives, ordnance.

Although the enumeration of the many advantages of large-scale production presents a very strong argument for such a form of economic organization from the social viewpoint, there are, nevertheless, various elements which interfere with such a complete organization of economic enterprise. Certain enterprises do not lend themselves to large-scale operation. Some of the general types of industry in which small-scale production is necessary are:

1. Industries whose product can not be standardized and establishments which attempt to make products to suit the differing tastes of consumers. Such industries produce "tailored" suits, high-grade furniture, art goods, finely bound books, etc.

2. Industries producing for a small market, such as those manufacturing artists' materials, nets and seines, models and patterns.

3. Industries in which the local market is small and whose product has a high transportation cost. In the manufacture of artificial-stone products, or bricks, in many localities, the activity could never be conducted on a large scale because of the limitation of the market for its product and the expense of transportation.

4. Industries in which the material used is widely scattered and cannot be concentrated because of high transportation cost or rapid deterioration. Cheese factories and cider mills may be included in this class.

5. Industries in which skilled labor is the chief element, such as engraving, job printing, etc., whose

products are really services rather than commodities.

The problem of the scale of production can be significantly analyzed only by recognizing the many factors which enter into each particular situation. No general theory can be of any great value. In addition to the factors already mentioned, there are numerous others, such as the amount of labor warfare in the industry, which often favors smaller shops; the managerial capacity of the enterpriser; the general trend of the industry as a whole, since it is much easier to develop large-scale production in an industry which is expanding rapidly than in one which is steadily losing ground; the traditional nature of the enterprise, etc.

To summarize: Until 1914, industry as a whole showed but little tendency toward an increase in average size of plant, but there was a noticeable growth from 1914 to 1919. Those developments present are chiefly the result of the unusually rapid expansion of certain industries in which production is carried on in large establishments and the more nearly complete utilization of plant in the abnormal year of 1919. There is no adequate measure of increase in the industrial capacity of establishments.

Throughout industry as a whole, no general tendencies of growth can be found. Although the number of large-scale establishments is rapidly increasing, the size of establishments at any given moment varies to a marked degree from industry to industry. The tendency to increase or decrease in size varies both from industry to industry and from period to period. The problem of the scale of production, therefore, is one of particular industries and even of particular period, the factors entering into each situation being often very different and always very numerous.

Advantages inherent in vertical combination are, according to one of the leading students of the question, that it:³

³ Farnham, "The Vertical Trust," *Industrial Management*, May, 1924, p. 258.

"1. Insures a lower cost of manufacture through the continuous quantity production of standardized articles.

"2. Saves expense through consolidation of administrative, sales, advertising, insurance, etc., departments. Sells only to ultimate consumer.

"3. Saves transportation charges on raw material and finished product (especially where a certain amount of horizontal consolidation is combined with the vertical.)

"4. Provides for pooling of knowledge, methods and processes.

"5. Assures a uniform quality and low cost of raw materials.

"6. Makes maintenance of superior quality possible.

"7. Reduces interest and depreciation on stores of raw material and semi-finished and finished products.

"8. Reduces amount of capital required per unit produced. No money passes until consumer pays.

"9. Increases ease of financing—securities are more liquid and more stable.

"10. Permits use of research laboratories—and all that this implies.

"11. Increases security of patents and trade marks.

"12. Permits securing highest class of administrators and executives.

"13. Permits retention of highest class of staff experts—lawyers—engineers—chemists, etc.

"14. Makes the most effective type of administrative methods possible.

"15. Places the industry in a strategic position of great strength."

The methods of concentration, usually, through inter-corporate stockholdings, are made possible through the transferability of corporate shares, and are necessary owing to the immobility of capital and inadequacy of capital funds. Prior to 1888, when New Jersey raised the restriction, it was impossible for one corporation to hold the shares of another. Since that time most of the important incorporating states have followed the lead of New Jersey until the practice of inter-corporate

holdings has come to be common among business units.

Since the tools of production, such as factories, machinery, and the like, cannot be profitably dismantled and removed from one area to another, it becomes necessary to discover some other means of accomplishing the desired end. Thus the practice has arisen, and is quite uniformly followed, whereby the producing unit maintains its *status quo*, so that its identity remains as it was formerly, but has its policies determined by the centralization of voting control through channels to be discussed later.

Since the method described above requires only a controlling interest it follows that the necessary capital outlay is reduced by almost one-half of what would be necessary to purchase the physical equipment of production. This method of acquisition is likewise enhanced by the common method of exchanging the stock of the purchaser for that of the seller.

By these means large scale production is accomplished with a minimum loss in production or financial outlay, but with a large degree of saving in the conduct of business enterprise.

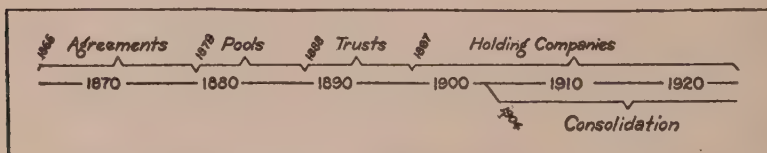
The business cycle.—The movement toward concentration is enhanced by the fluctuation of demand, due to variability in economic conditions. The economic “ups” and “downs” are the factors which constitute the economists’ business cycle concept. In periods of depression the weeding out process described in the previous paragraph is stimulated, and the inefficient are absorbed by the efficient concerns more rapidly, or else the former lose out entirely. Conversely, in times of prosperity, even the weak members in a particular field may survive. Or, if the economic conditions were consistently *good* or consistently *bad*, the fatality would be less, due to the fact that business forecasting would be more accurate. Thus, the strategic position occupied by the stronger concerns would be reduced, or the unfavorable position of the less efficient made more favorable, in direct proportion to the leveling of the peaks and depressions in the business cycle.

Devices for Reducing Competition.

The movement just described has found expression in a variety of inter-relationship devices which evolved in successive stages until the present forms have reached a state of general social acceptance. In order of their development these devices are:

1. Informal Agreements.
2. Formal Pooling Agreements.
3. The Trustee Device.
4. The Holding Company Device.
5. Consolidation.
6. Trade Associations.

These forms should not be designated pure "types of enterprise" but are merely adaptations of the simple forms discussed in Part I, used to bring about the desired end—the reduction in destructive competition. The following graphic description of the development of these forms will serve to fix in the reader's mind the period in which each predominated, although it should be understood that the periods have overlapped to some extent.



Informal agreements.—The first business interrelations took the form of understandings and agreements among competing enterprises for the purpose of directly controlling the prices of the products manufactured or services rendered. This first step in the evolution of big business was taken between the years 1865 and 1879, but the informal agreement has existed side by side through subsequent decades with the other more effective forms of combination and consolidation, and finds expression in trade and manufacturing associations, chambers of commerce and other organizations.

Some writers do not see fit to distinguish accurately between *agreements* and *pools*, but for our purpose we may consider agreements as being informal arrangements formulated to manipulate the price directly, and pools as more formal arrangements having as their purpose the manipulation of supply and demand factors which more indirectly apply to price determination, instead of to the price itself.

There are several classical examples of early agreements, one or two of which are presented here for illustrative purposes. One of the most informal of these was the so-called "Gary dinners" which occurred in 1897, some time after the period of predominance of this form of coöperation in all its fullness, but which serves as an excellent example. These dinners were attended by representatives of from ninety to ninety-five per cent of the whole trade, the purpose being to prevent the demoralization of the business, and to maintain as far as practicable the stability of the business and to prevent by agreement the wide and sudden fluctuation of prices, which would be injurious to everyone interested in the business of iron and steel manufacture.

This proposal of coöperation was well supported by manufacturers of iron and steel products and an elaborate scheme for controlling prices was developed. A general advisory committee consisting of five members was appointed having Mr. Gary as its chairman. This main committee appointed nine sub-committees, one on ore, one on pig iron, and so on, these committees holding meetings more or less regularly in different parts of the country, each manufacturer being questioned in regard to his percentage of the business and productive operations. Discussion centered about the question as to whether or not the published prices of the United States Steel Corporation, which they were to follow, were placed at the proper level. The chairman made it clear that agreements could not be enforced, and that there would consequently be no concrete agreement, no penalties, no restriction of output, but only an understanding that it would be the uniform policy to market their products at

the prevailing prices until they should further notify their competitors that they wished to put a new price into effect. Thus, there was only a moral obligation to keep the agreement or understanding.

The policy of coöperation was temporarily abandoned in February, 1909, when a number of independent companies refused to continue operation under the agreement and sold at their own prices, owing to the fact that the business encountered a falling off in demand and a consequent increase in competition for what demand might exist. But the dinners and the old policy were resumed late in 1909 lasting until 1911, when they were discontinued after the investigation of the Stanley Committee in congress.

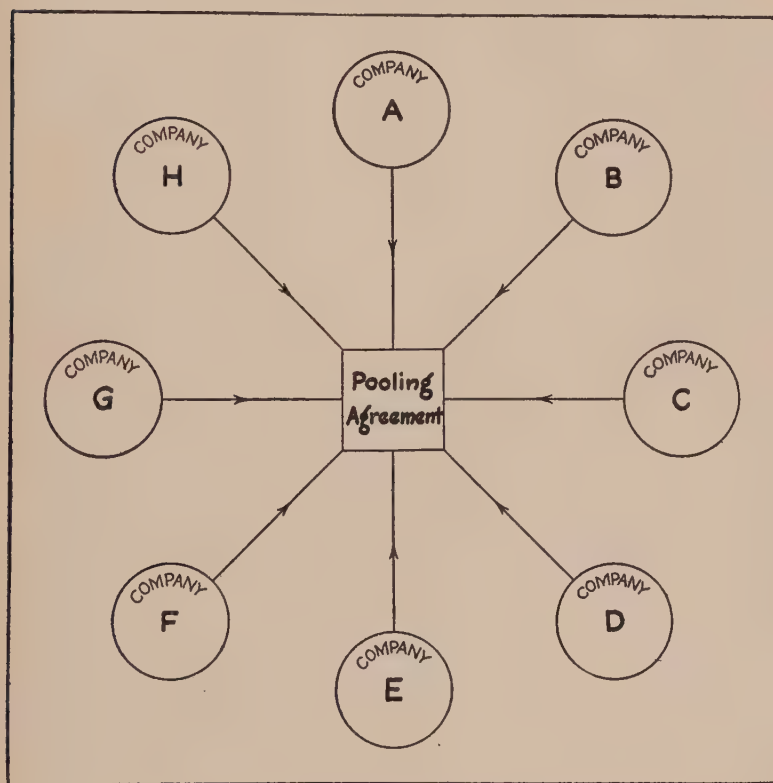
The earlier case of the Gunpowder Trade Association affords an example of a more rigid agreement with an organization for its administration, and having a system of fines and penalties. In this case a written agreement was drawn up and signed by members desiring to enter the association controlling the prices of gunpowder. The agreement provided the association should meet quarterly, the affairs to be administered by the officers common to any organization. A council made up of members from five associated enterprises was to be elected at the first meeting of the association, and annually thereafter, it being the duty of this body to meet weekly, to consider all questions of discrepancy and deviation from prices in the different home markets, all written complaints of infraction of the agreement by any member of the association, and to determine what penalty should be exacted against the offender. At one time the penalty amounted to one dollar a keg for all kegs of powder sold below the agreed minimum. The associated members shared the expenses of administration in proportion to the votes allowed them, votes varying with the size of the enterprises.

Pools.—The more formal pool, as a relationship existing among enterprises, having as its purpose the restriction of competition, sought to maintain favorable prices, an aim similar to that of the agreements previously discussed, but only by manipulating the price-determining

factors, such as the supply of the product or the market areas. Thus, the types of pools fall into three classes:

1. Pools regulating output.
2. Pools regulating markets.
3. Income pools.

The following simple diagram is illustrative of the relationship existing among the different pooling members where eight companies sign the agreement:



Pools regulating output—the whiskey pools.—As an excellent example of the pooling of output, reference may be made to the earlier developments of combination in the distilling industry in the United States. In order to appreciate the true nature and functioning of such a

pool it is necessary to turn back to the historical evolution of the industry as such, in order to discover the factors which contributed to over-production, which in turn lead to the employment of corrective measures through pooling agreements.⁴

The germ of over-production was planted in Civil War times, when a federal government tax on spirits, designated only to produce revenue, resulted in an unexpected increase in the total output of whiskey and the multiplication of productive units within the industry.

Between the years 1862 and 1865, the tax rose from 20 cents to \$2.00 per gallon. The fact that the tax was levied against the amount produced rather than on the amount sold, led the producers to distill large surplus stocks just before it became evident that the price of whiskey must rise in the market because of additional taxation. Thus, whiskey, distilled in 1862, when the tax was only 20 cents per gallon, could be sold in 1865 at an advanced price amounting to \$2.00 per gallon more than the price existing in 1862. In addition to increasing the output of existing plants, the tax thus resulted in stimulating the creation of new distilleries. When, after the need for further tax advances had disappeared and the frenzy incident to speculation in whiskey had cooled, the industry found itself tremendously over-stocked both in gallons of liquor and productive facilities. To aggravate the situation, the demand for alcohol in industrial uses had fallen off to a considerable extent, due to the high prices growing out of the federal tax program, and some illicit distilling had also contributed to the embarrassment of the distillers.

The situation was somewhat relieved, temporarily, by virtue of the fact that the European market absorbed a considerable of the surplus over a period of years when successive crop failures there reduced stocks for foreign consumption. But this market again stimulated further building of distilleries, the net result being a still further excess of productive enterprises in the field.

⁴ For the complete story, read Ripley, "Trusts, Pools and Corporations," Chapter II.

It will at once be obvious that the survival of all of these enterprises was economically impossible when perfect competition was left free to operate. The proprietors, therefore, determined to effect an organization for the purpose of limiting output in order to maintain the price where all would benefit, through monopolistic conditions. In 1881 the first of these whiskey pools was formed to remedy the situation just described, and in addition, to alleviate the embarrassment caused by inability to utilize the by-products of liquor manufacture used in the feeding of cattle, which were being raised in large quantities and could not survive a cutting down on the by-products. This pool was called the Western Export Association, the members being representatives of the firms subscribing to the agreement, each plant being assessed in proportion to its production, to finance exportation of spirits in order to reduce the glut in the home market. The pools continued to exist until 1887, breaking up and re-forming almost annually, sometimes limiting the production of member plants, in addition to exporting the surplus or discontinuing production in some plants by "buying off" the distillers.

In 1887, after a period of more or less indifferent success, the distillers abandoned the pooling agreement, substituting in its place the trust device, and in this capacity will again be considered in the chapter on trusts.

Pools were effected, during the pooling period, in other industries. In the cotton bagging industry a pool was formed in 1888, power being given to a central committee to order a curtailment of output of the individual mills. In the Michigan Salt Association (1868) if a member shipped in excess of his allotment, a penalty was provided for. In the steel industry, The Wire Nail Association (1895) was an important pool, division of output being made, and the amount of product going into the market regulated each month.

Pools regulating markets.—A good illustration of this is found in the international trade of the tobacco industry. In September, 1912, the American Tobacco Company (American Trust) and the Imperial Tobacco Com-

pany (a British Combination) entered into an agreement whereby the trade of the United States, Cuba, Porto Rico, Hawaii, and the Philippines was reserved to the American Tobacco Company and the trade of Great Britain to the Imperial Tobacco Company. Later the two companies organized the British American Tobacco Company to handle the trade in the rest of the world.

Another classic example of this form of pooling agreement is the case of the Addyston Pipe Company, 1894-1899. The members of the agreement were:

Addyston Co.....	Cincinnati, Ohio
Dennis Long & Co.....	Louisville, Ky.
South Pittsburg Co.....	S. Pittsburg, Tenn.
Chattanooga Co.....	Chattanooga, Tenn.
Anniston Co.....	Anniston, Ala.
Howard Harrison Co.....	Bessemer, Ala.

These companies manufactured cast iron pipes and sold particularly to municipal governments, water and gas companies, and large institutions accustomed to invite bids from various concerns. Under this agreement the pool divided the territory of the United States into "reserved cities," "free territory," and "pay territory." The reserved districts were assigned to different companies respectively under the resolution of December 28, 1894: The Addyston Pipe and Steel Company shall handle the business of the gas and water companies of Cincinnati, Ohio, Covington and Newport, Ky., and pay the bonus hereafter mentioned, and the balance of the parties to this agreement shall bid on such work such reasonable prices as they shall dictate.

Dennis Long and Company of Louisville, Ky., shall handle Louisville, Ky., Jeffersonville, Ind., and New Albany, Ind., furnishing all the pipe for gas and water works in above named cities.

The Anniston Pipe and Foundry Company shall handle Anniston, Ala., and Atlanta, Ga., furnishing all pipe for gas and water companies in above named cities.

The Chattanooga Foundry and Pipe Works shall handle Chattanooga, Tenn., and New Orleans, La., furnishing all gas and water pipe in the above named cities.

The Howard Harrison Iron Company shall handle Bessemer and Birmingham, Ala., and St. Louis, Mo., furnishing pipe for gas and water companies in the above named cities; extra bonus to be put on East St. Louis and Madison, Ill., so as to protect the prices named for St. Louis, Mo.

South Pittsburg Pipe Works shall handle Omaha, Neb., on all sizes required by that city during the year 1895, conferring with the other companies and cooperating with them; thereafter they shall handle the gas and water companies of Omaha, Neb., on such sizes as they make.

Free territory was territory without any restriction. Any company could sell there without reference to the agreement. Thirty-six of the States in the Union were designated as "pay territory" in which sales were made under conditions laid out by the representative board of the companies.

Income pools.—Both the Addyston Pipe Pool and the Wire Nail Association, mentioned above as being output pools, had additional features concerning the pooling of profits. In the pipe combination it was provided that the price charged on contracts for supplying pipe to customers in "pay territory" should be fixed by the central board made up of representatives of the six member mills or shops making pipe. To secure the contract each member bid by an amount larger than the price set by the board, the contract going to the highest bidder, the difference between the price set by the board and the higher price bid by the company securing the contract going to the board, to be distributed later among the parties to the pooling agreement, the share of each being determined by the productive capacity of each participant.

In the case of the Wire Nail Association, the amount of output was regulated, but in addition all income or profits above a cost price assumed by the association was pooled and distributed among the members of the association in a proportion equal to the proportion of allotted output.

Another modification of profit pooling was to be found in the sales association known as the Michigan Salt Association, one of the earlier pooling attempts running, roughly, through the seventies and eighties. According to the charter of this association the organization would exist for a period of five years. The organization plan was simple, the purpose being to manufacture and deal in salt and to transport the product to the market. Capital stock was issued amounting to \$200,000 at \$25 a share, but the actual amount paid in was only \$2. The board was composed of nineteen members, chosen by stockholders, no two members being chosen from the same member company. It was provided in the by-laws that stockholders should be manufacturers of salt and that the number of shares taken by any one should not exceed one share of the capital stock for each barrel of average daily capacity of his manufactory. The relation existing between the members was contractual:

Every manufacturer, in becoming a member of the association, shall execute and deliver to it a contract for all salt manufactured by him or them, or a lease of his salt manufacturing property, including all apparatus and appurtenances thereunto belonging, for the purpose of manufacturing. Such contract or lease shall be for the term of one year, or until the dissolution of the association, and shall not impose any restrictions that will prevent the manufacture of salt at any and all times.

It was further provided in the contract that the association as a sales agency for its members might require that each member turn in the product to the association daily; that a member could borrow money from the association against the product turned in; and that there should be no limitation on output, but for every barrel of salt sold otherwise than through the association the member producer must pay ten cents to the association. After an annual dividend of seven per cent on the stock held by the members, any surplus was distributed to members in proportion to output.

Advantages and disadvantages of agreements and pools.—The following outline is suggestive of the relative

advantages and disadvantages of these forms of combination:

Advantages.—

1. Facility of formation.
2. No overcapitalization, since the combination was loose and sought only to manipulate price without permanent monopolistic organization.

Disadvantages.—

1. Reduction of output and manipulation of prices replaced efficient management as a device to increase profits, thus reducing initiative.
2. Lack of stability, due to: (a) unenforceability of contracts creating the pool; (b) withdrawal of members, or their unwillingness to coöperate.
3. Generally illegal.

Problems.

1. Look up the records in magazines and newspapers for the year 1927 in order to discover something about the destructive nature of competition in the oil fields.
2. Show that the *low* price of gasoline for that period may have actually been a *high* price, considered over long periods of time.
3. Would you advise modifying the Sherman Anti-trust law to permit combination in oil production? Give your reasons.
4. (a) Is Ford Motors a horizontal or vertical combination? What about General Motors? (b) What are the advantages in each case?
5. What would probably happen in the automobile industry in case a severe business or financial depression should set in?
6. (a) Show how the action suggested in problem 5 might have been taken through the use of agreements or pools in the "old days." (b) Why can these methods not be used to-day?

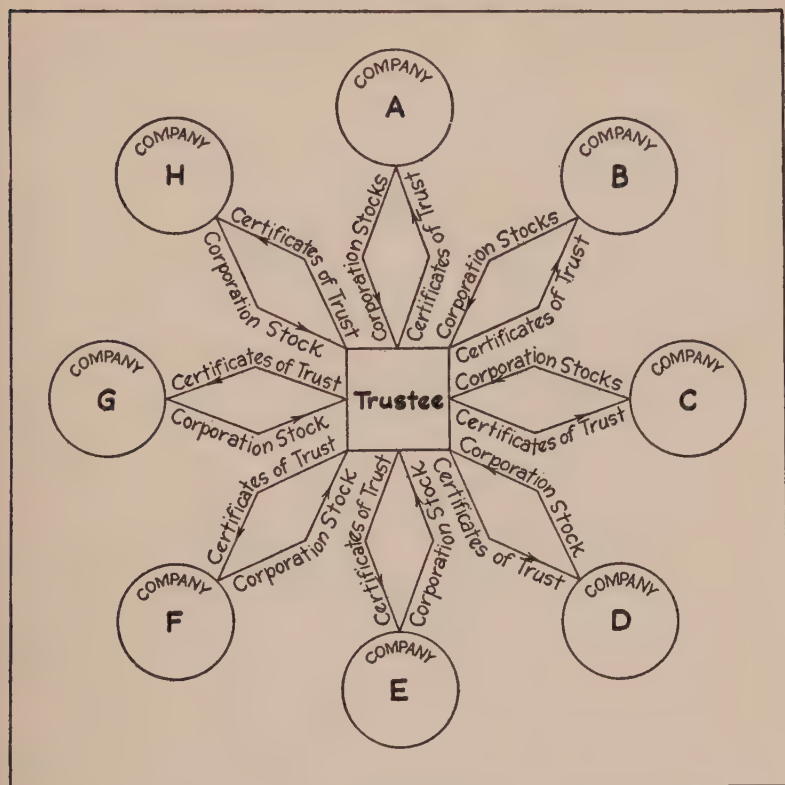
CHAPTER XIX

THE DEVELOPMENT OF "BIG BUSINESS": THE TRUSTEE DEVICE AND COMMUNITY OF INTEREST

Devices for Reducing Competition—Continued.

The trustee device.—The period from 1888 to 1897 witnessed the second step toward concentration for the purpose of market control, this form being commonly known as the "trust," the purpose being identical with that of the pooling agreement, but the goal being realized through a different device. Experience showed that a mere agreement was not sufficiently binding and, since it could not be enforced under the common law and its violation carried no penalty, conflicting interests thus led to inevitable dissolution. In order, therefore, to secure a tighter and more binding means of combination, the universally employed trustee device was seized upon and a special application of it was made to secure the desired end. The diagram illustrative of the pooling agreement in the preceding chapter is reproduced on the next page in a slightly modified form to elucidate the true nature of the trust as a form of combination.

It may be observed that the agreement of the pooling structure is here supplanted by a trusteeship. In the main, large scale enterprises of the decade marked by the introduction and development of the trust device had come to be corporations. By this device, arrangement was made by which the shares owned by the stockholders of the organizations to be combined were conveyed to trustees, who should have the voting rights incident to stock ownership and who were compelled to carry on the business of member concerns in the interests of the real



owners who received, as formerly, the distribution of profits through dividends. Upon surrendering title to their shares by deposit with trustees, the stockholders received in exchange trust certificates representing the value of the property surrendered. By making use of the control over the policies of the constituent companies through possession of voting power, and because of the transfer of title to the stock, the relationship became a binding one, and thus accomplished the desired end where mere pooling agreements had failed. It will be seen that even this form was eventually discarded but for cause differing from that effecting the downfall of the pool.

The Standard Oil interests were pioneers in the experimental use of the "trust" form. Before 1870, John D. Rockefeller and his associates acquired many oil con-

cerns in the interest of the Standard Oil Company, but many of those shares were registered in the names of different individuals instead of under the name of the Standard Oil Company. In order to centralize the control of these properties, the Standard Oil "trust" was organized 1879. This trust agreement was revised in January¹ to include over forty companies, controlling from ninety to ninety-five per cent of the refining capacity of the United States.² The trust agreement provided for nine trustees, (John D. Rockefeller, William Rockefeller, H. M. Flagler, and John Archbold being among them), to whom the stockholders assigned their shares of stock of the different companies. They consequently lost title of the stock so assigned, but in return, they received from the trustees the trustee certificates which gave them a proportionate title to all the properties and interests held by the trustees. The total number of certificates issued was 700,000 of which number the nine trustees owned 466,280, four of them holding the majority figure. So the power of management and control rested in them entirely. Powers of the trustees provided by the agreement were similar to those of the directors of a holding company. They had the power to vote for directors of the different constituent companies, but the dividends were to be distributed to the original stockholders after they had been collected by the trustees. It was further provided that the trustees had the power to use any of the surplus funds to purchase securities of companies in the same line of industry, and to hold them for the benefits of the trustee certificates. The agreement provided that the trustees had the power to change physical properties of the different plants; to form a new Standard Oil Company in any state in the Union; to take in new corporations or individuals. The term of agreement was for a period of twenty-one years "after the death of the last surviving trustee," but the agreement might be terminated within one year with the vote of nine-tenths of the

¹ Report of Com. of Corp. on Petroleum Industry, pt. 1, pp. 361-370.

² Brief for United States in Standard Oil Company v. United States (no. 725), Volume 1, p. 48.

total number of trustee certificates outstanding, and ten years with vote of two-thirds of the certificates.

The decade after the formation of the Standard Oil Trust witnessed a great increase in the use of this form of business organization. In 1884, there was the American Cotton Oil "trust," including some seventy mills in the South, modeling its organization upon that of the oil trust. In 1889 it was organized as the American Cotton Oil Company. Then came the whiskey industry, the sugar refining industry, both of which followed the example of the Standard Oil and met with the same fate.

The Whiskey Trust was organized in 1887 after five years of previous existence as pooling agreements among the leading distillers. The trust, known as the Distillers and Cattle Feeders Trust, consisted of some eighty concerns, mainly located in New York, Ohio, Indiana, Illinois, Wisconsin, Missouri, and Nebraska, manufacturing from eighty-five to ninety per cent of the total output of alcohol and spirits in the United States. The agreement also provided for nine trustees. In the same manner as the oil trust, the trustees acquired control of the different constituent companies by issuing trustee certificates in exchange for controlling interests in stocks. They controlled the market by limiting production instead of exporting the surplus output as did the old pools. As a result they closed some sixty-eight of the distilleries in order to concentrate their manufacturing in the best equipped plants.

The sugar refining industry formed its trust, the agreements being substantially similar to those of the oil trust, in 1887. There were seventeen companies owning twenty refineries with the refining capacity of 78 per cent of the total national output. The name was the Sugar Refineries Company, and it was managed by eleven trustees. Trustee certificates amounting to \$50,000,000 were issued to acquire controlling interests of the different companies. It was provided that 15 per cent of the trustee certificates allotted to the several companies were to be held by the board of trustees and those, with any part of the unissued stock from the \$50,000,000 were to be used to

secure interests or securities of other companies outside the trust. The agreement included an additional clause providing that no trustee could take an active interest, either directly or indirectly in the purchase or sale of sugar, "whether for the purpose of speculation or otherwise," unless approved by the Board. Twelve of the twenty companies acquired by the Sugar Refineries Company were soon dismantled, and the remaining eight were consolidated into four.

The trust movement resulted in general public opposition to the monopoly idea. As the result, six states, Kansas, Maine, Michigan, North Carolina, Tennessee, and Texas passed anti-trust legislation in 1889 and many other states later followed suit. The climax of the anti-trust movement in legislation came with the Sherman law passed by Congress in 1890. Then all these trusts met with their inevitable fate—dissolution. Ohio was one of those states active in condemning trust agreements; it dissolved the Standard Oil and the Sugar Refineries while the Whiskey Trust was dissolved in Nebraska.

Community of interest.—The community of interest may be defined as resting upon the personal understanding among stockholders or directors, or both, whereby the policies of several enterprises are determined for the good of all without any formal controlling mechanism. The first form of community of interest is secured when stock of several companies is held by members of any group of persons whose interests are closely related. Thus, the members of the group have some common interest which leads them to consult about and to agree upon directors of several companies—directors who are certain to act, for the most part, in harmony. It can hardly be doubted that communities of interest exist, somewhat after the fashion above indicated, in many cases where the old trusts have been forced to dissolve. Obviously, it is difficult to detect this form of combination in many cases and to bring it under the control of the government.

Interlocking directorates.—A second form of community of interest is illustrated by the interlocking directorships. Quoting Mr. Dewing, "this kind of community of interests is found in an industry where there is no other sign of coördination, and it is especially common in a manufacturing business made up of many separately owned plants confined to one geographical locality. In a one-industry town, for example, a dozen or more competing plants are engaged in the production of one and only one product, like the jewelry of Attleboro, the chairs of Gardner, or the shell goods of Leominster. In such a case a few prominent manufacturers, men recognized to be the leaders of the industry, will be found to be directors in a number of competing factories. They have small stock holdings in these competing organizations so that their horizon extends to the welfare of the industry as a whole and is not confined to one factory. Through the influence of these men some kind of harmony among all the producers in the town or locality is obtained. In no sense can it be said that there is real consolidation of operating plants, but there is a real coöperative unity based on mutual financial interest in each other's welfare and on a mutual understanding of each other's business problems. Yet the management of each part is free and unhampered."³

Advantages and disadvantages of trusts.—From the entrepreneurial standpoint the trust device had a two-fold advantage:

1. Permanence.
2. Centralized control.

Where the pool had been unstable due to the possibility of voluntary withdrawal of members to the agreement, the trust afforded stability on account of a complete surrender of a controlling interest, by each constituent corporation through stock transfer. Thus no withdrawal

³ Dewing, "Financial Policy of Corporations" (1921), Vol. IV., pp. 158-159.

was possible and central control thus established was free to determine the desired policies.

The principal disadvantage lay in the illegality of the device when used to attain monopoly through combination of competing business enterprises, either as *ultra vires*, as under the common law or in restraint of trade as under the state or federal anti-trust laws.

Advantages and disadvantages of the community of interest.—The community of interest is employed when only a loose intercorporate relationship is desired or is the only device which can be used. In general, it may be said that interlocking directorates are illegal, a fact which will be referred to at a later point, but some forms of community of interest probably exist at all times.

Problems.

1. What advantage had the trust over the agreement and pool?
2. Why can it not be used to-day?
3. Construct a chart to show how seven oil companies might form a trust, assuming this type of organization were legal. What advantages might result from this combination?
4. If their organization were declared illegal by the courts, show how they might retain their combination through various forms of community of interest.
5. Why could these relations not be long continued?

CHAPTER XX

THE DEVELOPMENT OF "BIG BUSINESS": THE HOLDING COMPANY; CONSOLIDATION

Devices for Reducing Competition—Continued.

The Holding Company.—During the period of 1890 to 1892, the trustee device came to a definite end as a permissible form of business organization when the Sherman law came into effect after several attempts of state legislation, attacking the common enemy—trusts—to protect public interest from the evils of monopolies. But the wheel of modern big business could not be stopped by one effort. Instead, due to the nature of operation of modern industry, bigness being essential, bigness still persisted in one form or another. Moreover, legally, a big corporation may be dissolved by a certain procedure of the court, but when it comes to liquidating a large pile of properties, valued at millions of dollars, as in the case of the Standard Oil Trust, it is not so easy a matter. That is why liquidation of the latter company was not complete even six years after the decree of dissolution, although this was not the entire explanation for the delay. Naturally it is not expected that leaders of the consolidations would be meekly willing to see their handiwork go to pieces, and it might be expected that they would continue the battle with their clever lawyers.

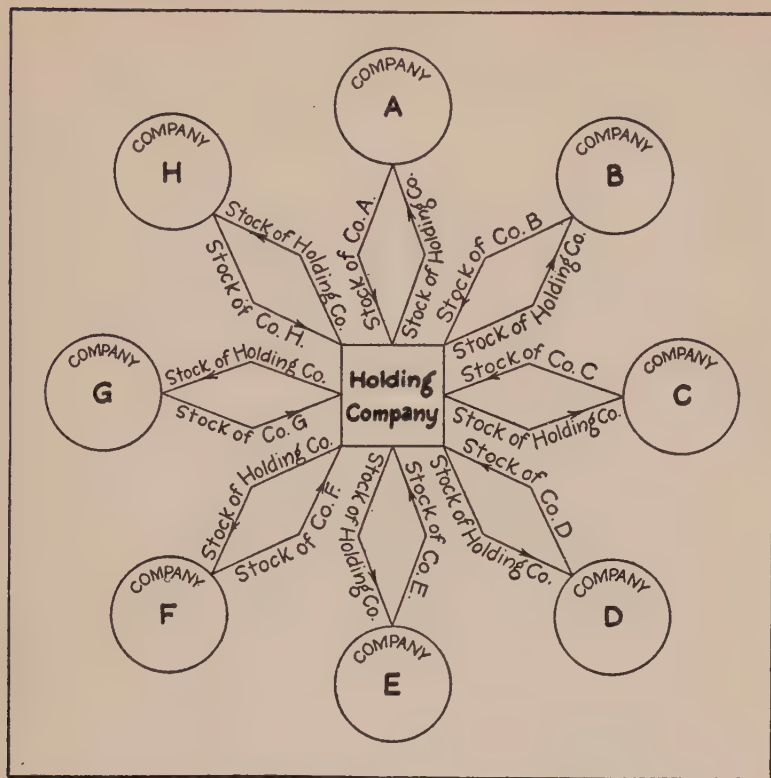
When looking for the device to meet this necessity of combination in modern industrial life, which had been expressed in the pool, the trustee device, and the community of interest, which are no longer legal, the capitalists found their refuge in the holding company. At about the time when Congress passed the Sherman Act, 1890, the state of New Jersey revised her general corporation

laws and legalized the practice of corporations holding securities of other corporations. Vast possibilities for combinations were involved in this fundamental change of the American corporation laws. Taking this legal basis, the holding company is organized for the purpose of acquiring stocks, and other securities, of other corporations. The acquisition of securities may be effected through exchange of securities, purchase or otherwise. When the holding company thus obtains sufficient controlling interests of the different allied enterprises, it elects directors to the different companies, and thus effects a binding combination under one management. A section of the charter of the United States Steel Corporation, a holding company, serves as a good description of the form:

To acquire by purchase, by subscription, or otherwise, and to hold or dispose of, stock, bonds, or any other obligations of any corporation formed for, or then or theretofore engaged in or pursuing, any one or more of the kinds of business, purposes, objects, or operations above mentioned; or of any corporation owning or holding the stocks or the obligations of any such corporations.

The last part is significant. The holding company does not limit itself to holding other operating companies only, but by the broad provision of the New Jersey law that "any corporation may purchase, hold, sell . . . the capital stock of, or any bond . . . created by any other corporations of this or other states, and while owners of such stock may exercise all the rights, powers and privileges of ownership, including the right to vote thereon," it can also hold securities of other holding companies. Thus the chain of the Standard Oil Company, the United States Steel Corporation, the American Tobacco Company, and many other concerns in other lines of industries were built up.

Structurally, the holding company is similar to the trustee device, and functionally, there appears to be almost no difference, as is indicated in the following modified diagram:



The principal differences are: that instead of a board of trustees, the holding company has directors of the ordinary corporation; and that instead of management of the enterprise by the trustees, which condition is effected by the nominal ownership of the stock transferred to them by the stockholders of the different allied concerns, the stockholders of the holding company elect their directorate to manage the affairs of the combination. In the trust, the stockholders surrender their shares of stock to be held in trust for them by the trustees, thus becoming "beneficiaries" of a trust agreement. In the holding company, shares of stocks are secured by a legally authorized corporation which by virtue of its nature, has the power to do so. In the trust agreement, a federate relationship was involved, in which the parties maintained a nominally separate existence, whereas the hold-

ing company is a nominally responsible corporation, buying stock in the open market and doing what the state has authorized it to do. In point of legality, the trust agreement is one "between an association of individual trustees and a group of corporations, which by implication give up their autonomy and so act *ultra vires*. It involves dealings between corporations which result in partnerships between them." With a holding company its practice of securing or disposing of stocks is entirely within its charter power, since it deals only with individual stockholders. So one is legal and the other is illegal, so far as the forms are concerned.

But the form is not of great significance under the anti-trust acts. When the Standard Oil and tobacco companies were prosecuted in restraint of trade the fact that they were holding companies availed them little. Their charters, granting them the right to hold stock in other corporations were little protection against accusations of operating "in restraint of trade." Thus, the holding company as a new form of enterprise involving intercorporate relationship, built upon legal foundations, is not exempt from the operation of the laws curbing restraint of trade and monopolistic tendency, since the court is likely to look, not upon the form alone, but also upon the intent and social consequence.

Illustration of a simple holding company.—A better understanding of the true character of the holding company device may be reached by brief reference to the structure of typical combinations of this form. A less complicated example may be found in the American Pneumatic Service Company which controls, through stock ownership, six subsidiaries as follows:

The New York Mail and Newspaper Transportation Company.

The New York Pneumatic Service Company.

The Boston Pneumatic Tube Company.

The Chicago Postal Pneumatic Tube Company.

The St. Louis Postal Tube Company.

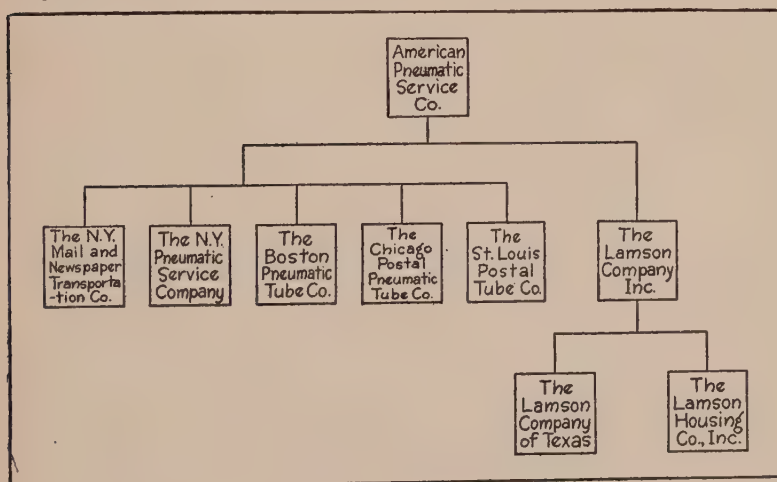
The Lamson Company, Inc., of Syracuse, New York.

The Lamson Company, Inc., in turn controls two sub-

sidiaries through the holding company device. The first of these is the Lamson Company of Texas, a small corporation having a capitalization of only \$2,500, a device resorted to by practically all corporations doing business in Texas to avoid the otherwise high taxation requirements in that state. The other subsidiary, the Lamson Housing Corporation, is designed to take care of housing development in the neighborhood of the factory for the benefit of employees, and is conducted as a separate proposition from the regular Lamson Company business.

All subsidiary companies are controlled through stock ownership and intercompany loans. The board of directors of the American Pneumatic Service Company is virtually the same as for each of its subsidiary companies. The president of the Lamson Company, Inc., and the Postal Tube Company are, respectively, the president, and vice-president of the parent company.

The parent company does little else than hold its investments in its subsidiaries, collect dividends from them, and in turn disburse dividends to its own stockholders. Each company has its own set of books and prepares its own statements monthly. Consolidated balance sheet and income accounts are also prepared monthly after the usual intercompany balances and stockholdings have been eliminated.



The simple chart on page 257 represents the structure of this holding company organization.

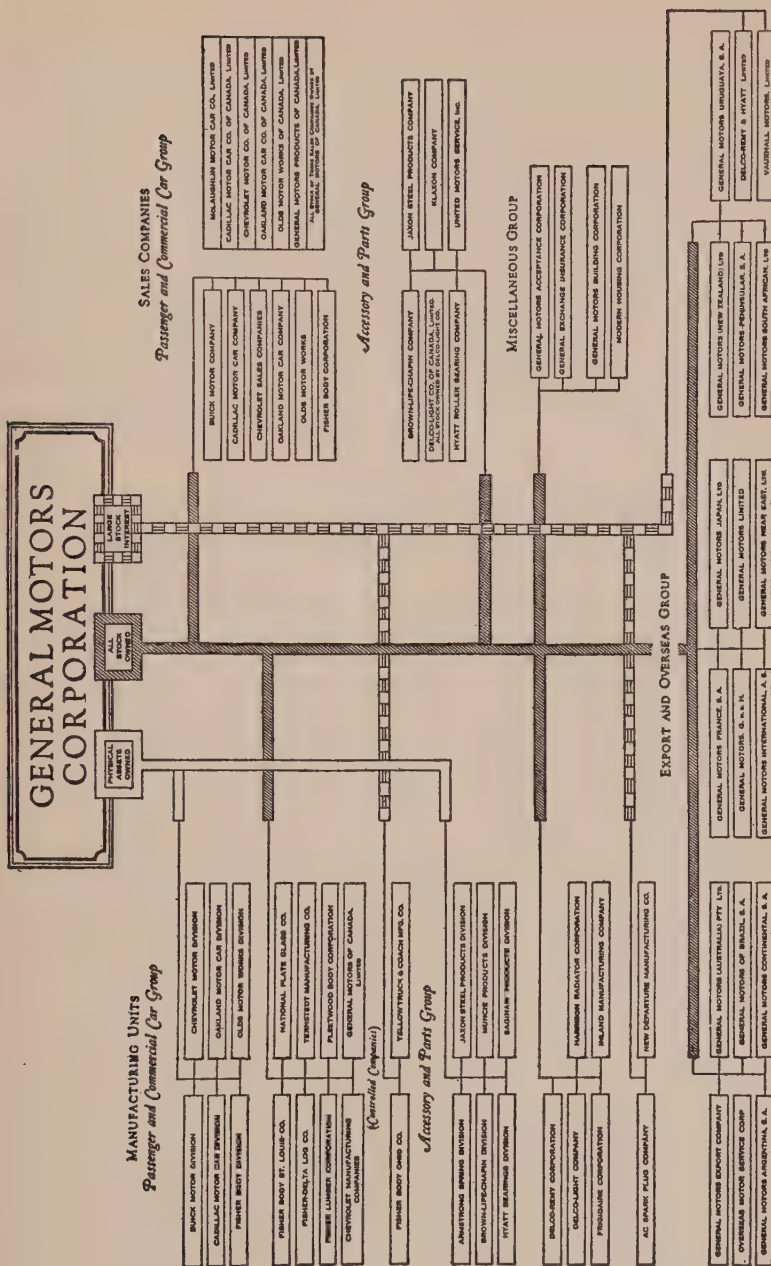
Standard Oil as a holding company.—We have already traced the Standard Oil Company through the evolutionary process of organization into the trust form and into the community of interest. The Ohio decision declaring the company illegal as doing *ultra vires* acts followed by prosecution against the company in other matters, finally drove it to embrace the holding company form in self defense, a position from which it was again dislodged in 1911, under the Sherman Anti-trust Act, as a combination in restraint of trade. Taking advantage of the New Jersey law permitting intercorporate stockholding, the Standard Oil Company of New Jersey was formed with an authorized capitalization of \$100,000,000. This company controlled:

- Eleven refining companies.
- Five lubricating oil companies.
- Three crude oil companies.
- Fourteen pipelines.
- One tankline company.
- Six sales companies.
- Sixteen natural gas companies.

In addition the company maintained sixteen companies carrying on foreign business and controlled a number of pipelines and refining companies.

As a result of the dissolution decree of the Circuit Court in May, 1911, the Standard Oil Company was broken up into thirty-eight separate companies, which may not have any directors or officers in common. Since the stock was not widely distributed, it became possible to retain a sort of community of interest by having common stock ownership as among the various companies.

The United States Steel Corporation.—The United States Steel Corporation provides an excellent example of a present day, legal, large holding corporation, illustrative of the vertical type of combination, as compared with the horizontal development of the American Pneumatic Service Company previously considered, as well



as the pyramiding process possible in this form of organization. The chart on page 257 shows how it becomes possible for one company controlling another through stock ownership, which in turn controls a third by the same means, to pile up a tremendous controlling interest in numerous enterprises by employing the holding company device.

Like the Standard Oil Company, in its holding company stage, the United States Steel Corporation has been attacked in the courts as a combination in restraint of trade, but succeeded in surviving the prosecution on the grounds that, in the light of the rule of reason it was not a monopoly in restraint of trade, even though its original intention was to accomplish this state of being. It can hardly be doubted that, had these cases been tried at approximately the same time, their status would have been determined as being about the same. However, the opinion in connection with the dissolution of the early Northern Securities Holding Company and the Standard Oil Company, in its holding company stage, has changed, and the rule of reason has been liberalized in its application to the holding company.

The General Motors Corporation.—One further case is necessary to illustrate the possibility of other forms of combination existing within the holding company. The General Motors Corporation has gained control of numerous subsidiary enterprises through a variety of methods, the chief ones being:

1. The purchase of physical assets.
2. The ownership of the entire stock.
3. The ownership of all the common stock.
4. The ownership of a majority of stock.

This sort of organization combines the holding company idea with complete consolidation. Such a combination may also include the leasing of property of other companies, an additional device used by some enterprises.

Reference to the organization chart on page 259, showing the financial structure of the General Motors Corporation, will aid the reader in visualizing the situation

existing where combination is effected through several devices.

General Motors Report.

GENERAL MOTORS CORPORATION is primarily an operating concern owning the plants, properties and other assets of its manufacturing operations which are designated in this list as Divisions. It is also a holding company owning part or all of the capital stock of other companies connected with its activities. These relations are indicated by numerals appended after the name of the companies:

1. *Assets owned by General Motors Corporation.*
2. *All stock owned by General Motors Corporation.*
3. *All common stock owned by General Motors Corporation.*
4. *Majority of stock owned by General Motors Corporation.*
5. *One-half interest owned by General Motors Corporation.*
6. *All stock owned by General Motors of Canada, Limited.*
7. *All stock owned by Delco-Light Company.*
8. *All stock owned by General Motors Export Company.*
9. *All stock owned by New Departure Manufacturing Co.*
10. *Majority of stock owned by New Departure Manufacturing Co.*

Passenger and Commercial Car Group.

BUICK MOTOR DIVISION ¹	Flint, Mich.
<i>Buick passenger cars</i>	
CADILLAC MOTOR CAR DIVISION ¹	Detroit, Mich.
<i>Cadillac passenger cars</i>	
CHEVROLET MOTOR DIVISION ¹	Detroit, Mich.
(Including Subsidiaries ²)	
<i>Chevrolet passenger and commercial cars produced in the manufacturing and assembly plants located as follows: Flint, Mich., motors, sheet metal and assembly; Detroit, Mich., forgings, gears, axles, differentials and wheels; Bay City, Mich., carburetors and hardened and ground parts; Toledo, Ohio, transmissions; assembly plants in these cities: St. Louis, Mo., Janesville, Wis., Oakland, Calif., Buffalo and Tarrytown, N. Y., Bloomfield, N. J. and Cincinnati, Ohio.</i>	
OAKLAND MOTOR CAR DIVISION ¹	Pontiac, Mich.
<i>Oakland passenger cars and Pontiac passenger and commercial cars</i>	
OLDS MOTOR WORKS DIVISION ¹	Lansing, Mich.
<i>Oldsmobile passenger cars</i>	

GENERAL MOTORS OF CANADA, LIMITED².....Oshawa, Ont.

Manufacture and sale in the Dominion of Canada of the Cadillac, Chevrolet, Oakland, Pontiac, Oldsmobile and McLaughlin-Buick passenger and commercial cars and GMC trucks; also cars marketed in Great Britain, Ireland and other overseas markets; plants at Oshawa and Walkerville, Ont.

YELLOW TRUCK & COACH

MANUFACTURING Co.⁴Chicago, Ill.

Coaches, GMC Heavy-Duty Trucks, Light Delivery Trucks, Cabs and Hertz Drivurself Cars. Plants at Chicago, East Moline, Ill., Pontiac, Mich., and Orillia, Ontario, Canada

FISHER BODY DIVISION¹.....Detroit, Mich.

(Including Subsidiaries²)

Including Fisher Body Ohio Company⁴, Fisher Body St. Louis Company², National Plate Glass Company², Ternstedt Manufacturing Company², Fisher Lumber Corporation², Fisher-Delta Log Company², Fleetwood Body Corporation². Automobile body plants in Detroit, Lansing, Pontiac, and Flint, Mich.; Cleveland and Cincinnati, Ohio; Buffalo and Tarrytown, N. Y.; Fleetwood, Pa.; St. Louis, Mo.; Oakland, Calif.; Janesville, Wis.; Memphis, Tenn. Plate glass plants in Blairsville, Pa., and Ottawa, Ill. Automobile body hardware plants at Detroit, Mich. Hardwood lumber mills at Memphis, Tenn.; Ferriday and Wisner, La.

*Accessory and Parts Group.*AC SPARK PLUG Co.⁴.....Flint, Mich.

AC spark plugs, speedometers, air cleaners, oil filters, mufflers and decorative tile

ARMSTRONG SPRING DIVISION¹.....Flint, Mich.

Springs for passenger cars and trucks

BROWN-LIPE-CHAPIN DIVISION¹.....Syracuse, N. Y.

Differential gears for passenger cars and trucks

DELCO-REMY CORPORATION².....Anderson, Ind.

Starting, lighting and ignition systems for cars and trucks; Klaxon horns; automobile lamps. Plants at Anderson, Ind., and Dayton, Ohio

DELCO-LIGHT COMPANY².....Dayton, Ohio

Delco-Light lighting and power plants; water pumps

FRIGIDAIRE CORPORATION ²	Dayton, Ohio
<i>Electric refrigerators, ice cream cabinets and refrigerating units</i>	
HARRISON RADIATOR CORPORATION ²	Lockport, N. Y.
<i>Radiators for passenger cars and trucks</i>	
HYATT BEARINGS DIVISION ¹	Newark, N. J.
<i>Hyatt anti-friction bearings</i>	
INLAND MANUFACTURING COMPANY ²	Dayton, Ohio
<i>Steering wheels, wood and hard rubber moulded parts</i>	
JAXON STEEL PRODUCTS DIVISION ¹	Jackson, Mich.
<i>Wheels, rims, tire carriers, rim parts, steel stampings</i>	
MUNCIE PRODUCTS DIVISION ¹	Muncie, Ind.
<i>Transmissions, steering gears, and chassis parts</i>	
NEW DEPARTURE MANUFACTURING COMPANY ³	Bristol, Conn.
<i>Ball bearings, coaster brakes, bells, bicycle hubs</i>	
SAGINAW PRODUCTS DIVISION ¹	Saginaw, Mich.
<i>Jacox steering gears for passenger cars and trucks; machining, grinding, and balancing crank shafts; gray iron and malleable castings</i>	
UNITED MOTORS SERVICE, INC. ²	Detroit, Mich.
<i>Provides authorized national service for Delco, Remy, Klaxon, Jaxon, Harrison Radiator, New Departure Ball Bearings, Hyatt Roller Bearings, AC Speedometers</i>	

Export and Overseas Group.

GENERAL MOTORS EXPORT COMPANY ²	New York, N. Y.
<i>Overseas distribution of General Motors cars and trucks in all overseas territories not covered by General Motors overseas operations; branch offices in important cities abroad</i>	
GENERAL MOTORS ARGENTINA, S. A. ²	Buenos Aires, Argentina
<i>Distribution of car and truck lines in Argentine Republic and Paraguay; assembly plant in Buenos Aires</i>	
GENERAL MOTORS (AUSTRALIA) PTY. LTD. ²	Melbourne, Australia
<i>Distribution of cars and trucks in Commonwealth of Australia; assembly plants in Adelaide, Brisbane, Melbourne, Perth and Sydney</i>	

- GENERAL MOTORS OF BRAZIL, S. A.².....Sao Paulo, Brazil
Distribution of cars and trucks in Brazil; assembly plant at Sao Paulo; branches at Porto Alegre, Recife, and Sao Salvador
- GENERAL MOTORS CONTINENTAL, S. A.².....Antwerp, Belgium
Distribution of cars and trucks in Belgium, Holland, and Switzerland; assembly plant at Antwerp
- GENERAL MOTORS FRANCE, S. A.².....Paris, France
Distribution of cars and trucks in France, Algeria, French Morocco and Tunisia; warehouse at Le Havre
- GENERAL MOTORS, G. m. b. H.².....Berlin, Germany
Distribution of cars and trucks in Germany, Austria, and Czechoslovakia; assembly plant at Berlin
- GENERAL MOTORS INTERNATIONAL, A. S.²....Copenhagen,
 Denmark
Distribution of cars and trucks in Scandinavian countries, Finland, Northern Russia, Danzig, Poland, Latvia, Lithuania and Esthonia; assembly plant at Copenhagen
- GENERAL MOTORS JAPAN, LTD.².....Osaka, Japan
Distribution of cars and trucks in Japan, Northern China, Korea, Manchuria and Siberia; assembly plant at Osaka
- GENERAL MOTORS LIMITED².....London, England
Distribution of cars and trucks in Great Britain and Ireland; assembly plant at Hendon
- GENERAL MOTORS NEAR EAST, LTD.².....Alexandria, Egypt
Distribution of cars and trucks in Egypt, Abyssinia, Albania, Arabia, Bulgaria, Greece, Italy, Jugo-Slavia, Palestine, Persia, Roumania, Syria, and Turkey; warehouse at Alexandria
- GENERAL MOTORS (NEW ZEALAND) LTD.²....Wellington,
 New Zealand
Distribution of cars and trucks in Dominion of New Zealand and adjacent islands; assembly plant at Wellington
- GENERAL MOTORS PENINSULA, S. A.².....Madrid, Spain
Distribution of cars and trucks in Spain, Portugal, Morocco, and adjacent islands; warehouses at Malaga and Madrid
- GENERAL MOTORS SOUTH AFRICAN, LTD.²....Port Elizabeth,
 South Africa
Distribution of cars and trucks in Union of South Africa and adjacent territories; assembly plant at Port Elizabeth

GENERAL MOTORS URUGUAY, S. A. ²	Montevideo, Uruguay
<i>Distribution of cars and trucks in Uruguay; assembly plant at Montevideo</i>	
DELCO-REMY & HYATT, LTD. ³	London, England
<i>Sales and service on Delco, Remy, and Hyatt products in Great Britain and Ireland; tech- nical and service headquarters in London</i>	
OVERSEAS MOTOR SERVICE CORPORATION ⁸	New York, N. Y.
<i>Sales and service overseas on General Motors and other accessory lines, including electrical equipment, bearings, etc.</i>	
VAUXHALL MOTORS, LTD. ⁸	Luton, England
<i>Manufacture of Vauxhall motor cars and sale in Great Britain and Ireland; factory at Luton</i>	

Miscellaneous Group.

GENERAL MOTORS ACCEPTANCE CORPORATION ²	New York, N. Y.
<i>Finances distribution of General Motors products</i>	
GENERAL EXCHANGE INSURANCE CORPORATION ²	New York, N. Y.
<i>Insurance for General Motors dealers and pur- chasers of General Motors cars</i>	
GENERAL MOTORS BUILDING CORPORATION ²	Detroit, Mich.
<i>Owns and operates central office building in Detroit</i>	
MODERN DWELLINGS, LIMITED ⁶	Oshawa, Ont.
<i>Housing for employees at Oshawa</i>	
MODERN HOUSING CORPORATION ²	Detroit, Mich.
<i>Housing for employees in Flint, Pontiac and Janesville</i>	
BRISTOL REALTY COMPANY ¹⁰	Bristol, Conn.
<i>Housing for employees in Bristol</i>	
NEW DEPARTURE REALTY COMPANY ⁹	Bristol, Conn.
<i>Housing for employees in Bristol</i>	

Sales Companies.

The capital stock of these selling companies is owned by the General Motors Corporation, except in the cases noted:

BUICK MOTOR COMPANY	Flint, Mich.
BROWN-LIPE-CHAPIN COMPANY	Syracuse, N. Y.
CADILLAC MOTOR CAR COMPANY	Detroit, Mich.
CHEVROLET SALES COMPANIES	Detroit, Mich.

ETHYL GASOLINE CORPORATION ⁵	New York, N. Y.
HYATT ROLLER BEARING COMPANY.....	Newark, N. J.
JAXON STEEL PRODUCTS COMPANY.....	Jackson, Mich.
KLAXON COMPANY.....	Anderson, Ind.
OAKLAND MOTOR CAR COMPANY.....	Pontiac, Mich.
OLDS MOTOR WORKS.....	Lansing, Mich.
CADILLAC MOTOR CAR COMPANY OF CANADA, LIMITED ⁶	Oshawa, Ont.
CHEVROLET MOTOR COMPANY OF CANADA, LIMITED ⁶	Oshawa, Ont.
GENERAL MOTORS PRODUCTS OF CANADA, LIMITED ⁶	Oshawa, Ont.
McLAUGHLIN MOTOR CAR COMPANY, LIMITED ⁶	Oshawa, Ont.
OAKLAND MOTOR CAR COMPANY OF CANADA, LIMITED ⁶	Oshawa, Ont.
OLDS MOTOR WORKS OF CANADA, LIMITED ⁶	Oshawa, Ont.
DELCO-LIGHT COMPANY OF CANADA, LIMITED ⁷	Oshawa, Ont.

Advantages and disadvantages of the holding company.—From the standpoint of the entrepreneur the holding company has the following advantages in the matter of combination:

1. Combination is facilitated by the fact that large control may be gained by the purchase of only a small proportion of the total amount of stock outstanding in each constituent company.

2. The allotment of territory to eliminate competition may be more easily effected than in the case of pooling.

3. Centralized control is made possible, while the member enterprises maintain their individuality, making de-organization possible by a mere re-exchange of securities.

4. All the advantages of combination and large scale production are realized with the minimum outlay of money and organization procedure.

As to disadvantages, it may be said that this form inherits all of the disadvantages of any corporation, when considered only from the standpoint of the entrepreneur.

In addition, the dilution of liability and responsibility due to the pyramiding process, and the increasing opportunity for inside manipulation of incorporate finances and policies, cause the investing public to hesitate before freely investing in this form of enterprise. The possibility of the disapproval of the government by means of the anti-trust legislation has had an inhibitory influence, also, upon its adoption. The ills accruing to society on account of all forms of corporate and intercorporate enterprise will be treated in a future chapter.

Consolidation.—Consolidation may be defined as a complete fusion of corporations instead of a mere federation as in case of the pool, trust and holding company. It may take the form of an amalgamation where two or more companies organize a new company with which to consolidate, or of a merger, where one of the companies already existing absorbs all of the rest of the enterprises, each of the various companies losing its identity as a business unit, although the plants themselves may continue to operate. In common practice, these terms are not used in their proper technical meaning, merger, consolidation, amalgamation, and even the term trust, being used more or less synonymously, when applied to the tendency toward “bigness” in business enterprise.

This form of combination cannot be carried out excepting as the consolidation scheme is undertaken by permission of state statute and with state approval. This requirement not only protects society against indiscriminate fusion of enterprise, but also protects the stockholders, especially those in the minority, from exploitation and loss. Gerstenberg has described the consolidation procedure thus:

“Where the corporations about to be consolidated were originally organized in different states, the consents of the several states must be obtained. The general rule is that ‘the consolidation of domestic and foreign business corporations (as distinguished from railroad corporations) is not as a rule permitted by consolidation statutes applicable to that class of corporations.’

“The procedure in consolidation is ordinarily as fol-

lows: The directors of the several companies pass resolutions ordering the consolidation and calling upon the stockholders to express their opinion. The stockholders, usually at a special meeting, consider the proposal to consolidate and if the number of individual stockholders required by statute sign written consents, a written agreement of consolidation is executed, which, with the written consents, is filed in the public offices wherein certificates of incorporation are filed. Thereupon the consolidated company comes into being and there remains only the exchange of certificates of stock of the consolidated company for the certificates of stock of the constituent companies.

"People familiar with such affairs realize that whenever any form of corporate reorganization takes place there are always some stockholders or creditors ready to raise objection, sometimes perhaps in good faith, but frequently for the purpose of showing that in objecting they are consistent with their past records in this respect, and more frequently, it is to be feared, for the purpose of forcing a settlement of their claims on a basis hardly to be distinguished from blackmail. It is important, therefore, that when corporations consolidate, they follow exactly the terms of the statute authorizing the consolidation.

"The statutes of some states, New Jersey, for example, provide that only such corporations as are engaged in the same or similar lines of business may consolidate. Here is a question for difference of opinion: are two companies that have formed a consolidation really in the same or similar lines of business? Suppose, for example, company A has powers x and y , and that company B has powers x , y , and z . May they consolidate, assuming that company B is not exercising power z ? It is a general rule of corporation law that corporations are not guilty of non-user of corporate powers if they do not exercise all their powers. With this latter rule in mind, consider what might happen to an investor who put his money in company A if the two companies were permitted to consolidate. He committed his funds, let us say to the hazards

of the x and y business; after consolidation, the consolidated company would have the joint powers of companies A and B and therefore would have the right to exercise the power z. The company might, in fact, decide to discontinue the exercise of its x and y business and concentrate on the z business. Thus, if powers x and y were those of building, buying, and selling real estate, and power z was that of dealing in automobiles, the consolidated company would become an automobile business and an investor in company A, who originally had no idea of committing his funds to any but a contracting and real estate business, would find himself in the automobile business. Hence, it would appear, the powers of the consolidating companies must not only be similar in kind but similar in amount.

“It would seem from what has been said that objecting stockholders may have two grounds for objection: (1) the proposed consolidation is illegal; (2) the stockholder does not deem it expedient. To protect himself from injury on ground (1), he may start an action for an injunction in an equity court, and to protect himself against ground (2), he may have recourse to certain statutes provided in most states for the protection of minority stockholders who do not wish to be forced into a consolidation against their will. These statutes usually provide that the disgruntled minority stockholder may apply to a court of equity which will appoint appraisers to appraise the money value of the applicant's stock. The appraised value is then paid by the consolidation, as well as the expenses of the proceedings for valuation, and the objector's stock is cancelled.

“The stockholders of the constituent companies become stockholders in the new company on an agreed basis, and the creditors of the constituent companies become creditors of the consolidated company, though their equities in specific properties are preserved as far as possible.”¹

¹ C. W. Gerstenberg, “Financial Organization and Management” (Prentice-Hall, Inc., New York), pp. 538-539.

Examples of consolidation.—When the so-called Sugar Trust was dissolved under the Sherman Act as being in restraint of trade, it maintained its status by the outright purchase of plants that would otherwise be in competition, instead of using the holding company device as did the Cotton Oil Trust, or the community of interest, as did the Standard Oil Company. In 1891 the company was incorporated in New Jersey as the American Sugar Refining Company. Most of the plants which had been purchased or were purchased later were abandoned, only seven being used for actual production.

Two other cases of consolidation merit brief reference—the Powder Trust through the process of merger, and the American Tobacco Company, through amalgamation. We have already discovered that early pooling agreements existed among the various producers of powder. As in other similar instances the Powder Trust embraced the holding company form, in this case the device being used between 1902 and 1904, surrendering in favor of consolidation in 1904. Reference to the chart on page 236 reminds us that the year 1904 marks the beginning of the wide adoption of consolidation procedure in place of the federated forms. It was in this year that one of the early holding companies, The Northern Securities Company, was held to be illegal and in restraint of trade, a decision which cast some doubt as to the legality of this form. It is probable that this doubt contributed to the decision to abandon the holding company device in both the Powder Trust and the American Tobacco Company.

The latter of the two companies mentioned above was a new company organized in 1904 to absorb the old Consolidated Tobacco Company, the Continental and the old American Tobacco Company.

Advantages and disadvantages of consolidation.—The weaknesses of organization ascribed to the holding company are somewhat obviated by combining through consolidation. Thus:

1. Dilution of responsibility and liability is replaced by a unified concentrated management, eliminating unnec-

essary officials and other expenses incident to maintaining a number of offices and independent plants.

2. Unity of interest resulting in greater confidence replaces the possibility of unfair manipulation of the affairs of the great variety of constituent companies making up a holding company.

3. The legal standing of consolidation where properly effected seems to be more secure than that of the holding company.

Similarly this form of organization surrenders some advantages inherent in the holding company form. The following brief list is suggestive of the true situation:

1. A greater outlay of capital is necessary when purchasing outright, as in the case of consolidation, instead of acquiring only a controlling interest of stock of the member corporations as in the holding company.

2. Consent of a large majority of the constituent companies is usually required, a fact making combination less easily effected.

3. Good-will built around firm names of the enterprises consolidated and patents, at great expense, must be sacrificed where it could have been preserved in the holding company form.

4. The possibility of territorial allotment of business common to the holding company is lost in consolidation.

5. De-organization is difficult where necessary, because of the complete transfer of ownership instead of a mere exchange of one share of stock for another.

The trade association.—A somewhat limited attempt toward coöperation among enterprises producing or marketing similar commodities or services is represented by the modern trade association. Let it be supposed by way of illustration, that manufacturers of ice coöperate in an advertising campaign for the purpose of educating the public to the qualities of ice as a refrigerant. This activity not only tends to increase the demand for ice in the entire industry, but also may serve to enhance the producers' position in competition with electric refrigeration mechanisms.

In addition to coöperative advertising, these associations join in carrying on propaganda against unfavorable legislation, in providing for production and marketing research, in establishing and maintaining trade ethics, in educating dealers, and in creating credit reporting agencies. The bitterness of competition may be avoided to some extent as the result of a spirit of fraternity and mutual interest which may be generated as a by-product of close association. The associations appear in the majority of industrial and commercial fields as well as in the professions. Typical examples are: International Advertising Association, Oil Heating Institute, The National Paving Brick Association, The National Association of Ice Industries, the Association of Metal Lathe Manufacturers, Inc., The Electric Hoist Manufacturers' Association, The Greeting Card Association, The Sheet Steel Trade Extension Committee, The American Gas Association, The Associated Dress Industries of America, The National Confectioners' Association, The National Lumber Manufacturers' Association, and The Silk Association of America. This list is only partially complete, but is indicative of the inclusiveness of the trade association plan.

The extent to which these organizations may function in maintaining uniform trade policies or in reducing competition is, of course, problematical. Certainly they cannot go far in restraint of trade without incurring opposition through the Federal Trade Commission. Many of their practices have been examined and discontinued by this government body. Apparently, each case of doubtful nature must be tried on its own merits, making it difficult to bring any very adequate checks to bear. However, the trade association does not yet seem to represent an adequate device for coöperation for the purpose of stifling competition.

Problems.

1. "While the holding company is structurally different from the trust, functionally, it secures similar ends." Explain.
2. Construct charts to show the differences and similarities between trusts and holding companies.

3. Name some holding companies other than those mentioned in the text.

4. Have all holding companies been held to be legal? Illustrate.

5. Under what circumstances are they legal? Illegal?

6. (a) How did consolidation serve to secure the advantages of other forms of combination?

(b) Why was it chosen in preference to the holding company in some cases?

PART III

THE SOCIAL IMPORT OF BIG BUSINESS

CHAPTER XXI.

THE SOCIAL EVILS OF "BIG BUSINESS"

No discussion of the evolution of "big business" and its present structure and control would be complete without considering the effect of the development upon the wider social interests as they apply to individuals and groups constituting society. Likewise, some notice must be taken of the efforts toward social control which have been extended through the state and federal governments. This latter treatment will be reserved for the following chapter. The evils incident to the growth of business enterprise may be classified, for convenience as:

1. Individual Handicap.
2. Misuse of Limited Liability.
3. Fraudulent Promotion and Reorganization.
4. Tendency Toward Monopoly.

The individual handicap.—We may first inquire as to what has been the effect of the development of the corporate form, especially where the element of great size has appeared, upon individual initiative and indirectly upon social welfare. Probably the most romantic period of American life was the era when individualism was predominant. In the colonial days and the decades following, while the great West was being settled, the hardships incident to the danger of pioneering developed sturdy manhood, traditions of bravery, honesty, and ambition which have been important factors in subsequent American life. This same spirit has been carried into industrial and commercial development, developments around which writers who have caught the spirit of the times have woven stories which are still read by millions. The development of steel, oil, transportation, and other

industries are illustrations of this romantic story of individual endeavor. Thus, it may be shown that danger and the presence of competition among individuals or small groups have been important contributing elements to sturdy American industrial and commercial life. It is to be feared that with the elimination of these stimulating forces, creating as they do the qualities of self-reliance, honesty, determination, ambition, and sterling character, society will be the loser, despite the supposed increased efficiency under the new economic system of large scale production. But the determination of the net result of the transition must lie in the future.

This view has been supported by the United States Supreme Court, which has held that:

“It is highly important in the preservation of society and in the development and elevation of the race, that the right to earn a livelihood, to engage in any commerce, employment, or labor, be kept free and untrammelled. It is not sufficient that the citizen be given merely an opportunity to earn a livelihood; the avenues of commerce and trade should be kept open. The man who has constantly before him the prospect of always being an employee in a subordinate position, who can never rise above it, who has no prospect of ever becoming a proprietor, who cannot enter the field of competition in industry, is not in a position to develop those faculties of independence and enterprise which make the highest type of man.”

We have seen that these qualities in our national life which have meant so much in the development of sturdy citizens have been greatly restricted by the development of enterprise to its present stage. Americans have always been known for their pluck, individuality, and initiative, which have been fostered by freedom of enterprise and the standard of personal liberty which has always been the prime consideration of our country. And now this liberty of development is decidedly menaced by the growth of the impersonal organization.

Limited liability.—In the consideration of the next point—the misuse of the limited liability power—it is

necessary to review a part of the picture of the corporate form of organization. One of the principal differences between the corporation and the partnership or sole proprietorship is the limited liability of the owners of the business. In either of the two latter types, the owner or owners of the business are responsible for all indebtedness incurred by the firm; that is, their personal property can be attached if necessary to secure full payment of all the company's obligations. This, of course, means hardship for the owner in many cases, particularly in the instance of a partnership, for then each partner is liable to the full extent of his assets for all the debts of the firm, though they be incurred by other members of the firm who have not the ability to share the expense. On the other hand this principle of unlimited liability gives to the creditors, bondholders, mortgagees, noteholders, or other creditors of one of these types of enterprise an assurance of payment which is altogether lacking in the case of a corporation owing to the limited liability granted to its owners. In nearly all corporations the stockholders or owners are liable only for full payment for the shares or portion of the business which they own. Nothing further can be demanded from them by creditors of the corporation save in the case of some financial institutions, such as banks, which have the double liability requirement, that is, the responsibility of each stockholder, for an amount equivalent to his investment should the corporation default in the payment of its debts. This particular stipulation is made with reference to financial institutions as it seems wise to have their fiscal backing more strongly entrenched. This exception is, in itself, a confession that the limited liability policy is of considerable danger to the corporation creditors. If it were not so, this safeguard for banking organizations would not be erected. The situation seems hardly fair to the creditors of mercantile, manufacturing, trading, and transportation corporations. The money which is lost by them each year in the failure or dissolution of these institutions shows that they, as well as creditors of financial houses, should be protected. Of course, it will be

argued that a double liability provision or some equally adequate safeguard will remove many of the corporate advantages, causing more restricted sale of stock, more strenuous requirements of the investor resulting in smaller capital, which in its turn would cut down production, decrease employment of labor and cause an economic depression. On the other hand, it can be pointed out that repeated losses on the part of creditors and bondholders does not make for the sound financial background necessary for economic health. This does not mean that the double liability would fit into the schemes of many corporations helpfully, but it does indicate that financial experts realize the limited liability of corporation owners is dangerous and that some remedy should be found for the protection of public welfare in this respect.

Promotion and reorganization.—The next great danger of the corporation to society is that financial manipulation may occur at the company's inception or reorganization. This manipulation is generally the result of that process known as "promotion," carried on by a promoter or group of promoters. Their functions may be quite legitimate and beneficial or they may be quite the reverse. Promotion of an industrial enterprise involves risk at best, and in the absence of scrupulous honesty there is much chance of corruption. For instance, the promoter holds property or options which will be useful to the corporation. The temptation is to overvalue such property, that is, to issue more stock against it than it will secure, ordinarily called overcapitalization. Under these circumstances, the innocent purchaser for value parts with his money and receives stock with a sadly inadequate backing. If any dividends at all are to be paid on such stock, the corporation must earn a fabulous rate on what it really has, and as this usually does not happen, either dividends are passed up and the stockholder receives no returns on his investment or the dividend is paid out of capital, thus decreasing the already slender backing of the stock owned. This works an injustice not only to the stockholder but also to the creditor and bondholder who

take the corporation at its face value. Of course, over-capitalization may be overcome by building up a fund out of profits to take care of the deficiency, but, as a rule, this is not what happens, for the promoter has taken as a reward for his efforts a block of stock which he desires to sell at top prices, and he will endeavor to boost the price of this stock by using his influence to secure the payment of large dividends to stockholders, and thus increase the public demand for such a seemingly profitable investment so that he can unload at a high price. This means not only that a reserve fund cannot be built up out of profits, but often unearned dividends are paid out of capital as described above with the resulting damages there mentioned. In theory of law, of course, dividends should never be paid, even when the corporation is capitalized according to its worth, if such payment results in a diminution of capital. A corporation must consider also the maintenance of its equipment and depreciation on the plant. Otherwise it would find that in a few years it had practically nothing with which to back its securities. "The chief purpose in declaring dividends when not truly earned is to influence the stock market and to enable the interested party to unload his stocks."

There is another phase of corporation procedure which is quite likely to lead to financial disaster. This is reorganization. A very large proportion of all our industrial corporations have gone through the process of reorganization. Sometimes this is undertaken for praiseworthy and lawful motives, but it may also be undertaken for fraudulent reasons. The laws of most of our states provide that there can be a reorganization with a change in the relative amounts of the securities, but there must first be a consent given by a majority of the outstanding stockholders. However, this is frequently circumvented by manipulation of the stock in favor of reorganization so it overbalances the unfavorable group. To best understand the unscrupulous side of reorganization we will take up the reasons found by United States investigation to be responsible in many cases.

1. To get rid of an obligation as cumulative preferred stock.
2. To avoid suits for illegal profits.
3. To head off prosecutions for violating trust laws.
4. To squeeze out small holders.
5. To obtain commissions by the new promoters of the reorganization.

The operations of the United States Leather Company illustrate reorganization for the first purpose. The International Harvester Company resorted to reorganization for the third reason.

A third danger, speculative management, is one about which little can be known and yet which causes as much disaster as any of those heretofore mentioned. Many American corporations fail to prohibit dealings in the securities of a company by its own officers. An unlimited power to contract loans without the approval of the directors or stockholders is a constant menace to conservative management. Another phase of the same matter concerns the temptation to industrial management with a view to its effect upon the stock market rather than upon the permanent welfare of the company (somewhat similar to the promoter's idea). Secrecy is a constant invitation to the insider to take advantage of forthcoming events at the expense of stockholders. Such speculative management encourages speculation in ownership by the stockholders. The investor who was confident in the stability of his company is replaced by the temporary stockholder who looks for his return, not through dividends, but through buying and selling and manipulation. These evils and excesses are largely due to the fact that there has been insufficient regulation and publicity in the financial projects of big business, and the managements have not been held responsible for their recklessness and inefficiency, which has at times resulted in actual dishonesty. There should be a strong stand by the government, not for repression—that has gone too far in many cases already—but for wise and steady inspection and direction.

Monopolistic trend.—The final point to be taken up against the corporation is the evil caused by the monopolistic trend of this form of enterprise. Whenever competition becomes too sharp there is a tendency to combine. This has been characteristic of business forms throughout the years, but has always been regarded with suspicion by the public, who feared that a resulting restraint of free trade might be harmful to their interests. There was always the prospect of an inferior product, or advanced prices, or lowered wages or a decrease in production if business is concentrated. A study of the old common law reveals the historic background of this attitude. It may be said that by common law, monopolies were unlawful because of their restriction upon contract among individuals, and their consequent injury to the public; that the freedom of the individual to deal in the necessities of life was restricted where the nature of such dealing was such as to manifest an intent to bring about an unduly high price; that to protect the freedom of contract in the interest of the individual and society, a contract of an individual in which he put an unreasonable restraint upon himself in the carrying out of his business was void. In this country it came to be recognized in accordance with the English rule, that contracts or acts which it was considered had a monopolistic tendency, especially those which were thought to unduly diminish competition and hence to enhance prices, were restricting the due course of trade, and, therefore, should be treated accordingly.

The danger from combinations of corporations can scarcely be overestimated, providing, of course, that there be no limitation, for it may be seen at a glance that corporations have more to tempt them to combine than individuals, for they can see ahead domination of their entire field if their endeavor is carefully guided. And once this position were reached, it could be held from any upstart competitor by any number of practices which we have seen operated within the past twenty years, such as maintenance of "fighting brands" cheaply contrived in order to put competitors out of business, blacklists and

boycotts, espionage and the employment of detectives, manipulation of the market, rebates, preferential contracts and the like. In fact it was the publicity caused by flagrant abuses of the freedom of trade that brought the dangers of the monopolistic trend of industry, and the crying need for regulation, to the attention of the legislators. Their first thought was to put an end to such procedure by repression. This has been the course pursued for some time, with decidedly poor results. Now we are coming to see that it is not so much the demolition of big business that is to be desired as it is the education of the public so that it will know how far industrial reconstruction and regulatory policies should go.

Whether or not the case against the tendency toward monopoly is as strong as we formerly believed, the fact remains that society has been convinced that the "competitive theory" to which it has been clinging through the decades, marked by the shifting development of enterprise, is the correct measure for determining the "goodness" or "badness" of business conduct. This criticism has been reflected in a number of laws designed to protect society against monopoly evils, passed by several of the states in the Union as well as by the Federal government. A study of these evils will lead, logically, to an analysis of the corrective efforts just mentioned. This analysis is being reserved for the next chapter.

The general evils of business are reflected more emphatically as the elements of size and power enter the problem, but that connected with the trend toward monopoly merits more detailed analysis in this connection, since it is this offense against which most of the legislation against big business has been directed. The problem is too big, however, for detailed treatment here, and must be passed over with a mere suggestion of its importance in the problem as a whole.

The case against monopoly.—It has been the belief of American citizens that "competition is the life of trade" and that under monopolistic control of business, prices must be higher and service poorer than under competitive business conditions. The argument is advanced that a

monopolistic unit controls the supply and may, at will, regulate the prices of commodities through artificial manipulation of the economists' supply and demand equilibrium. Even under the common law, that is, in America, prior to the passage of the Sherman Anti-Trust Law in 1890 and the state laws immediately preceding it, it was held that competition in business was socially advantageous although the courts interpreted the law to mean that certain combinations which were not materially in restraint of trade might be permitted.

In addition to the objection to the general *principle* of restraint of trade leading toward monopoly, criticism must also be made of the motives and *methods* used by enterprises to attain the desired ends. Combinations have been defended on the ground that they effect great savings through the application of the principles of large scale production. While such worthy motives may have been back of certain unifying efforts, it is just possible that pure monopoly control has too often been the ultimate goal. Even where the original purpose may have been legitimate the method employed has necessarily been objectionable.

Unfair competition.—Having attained whatever advantages accrue to a large scale production incident to capitalistic concentration, the organizers found that competition still existed where smaller units were able, through efficient methods of production or distribution, to remain outside the fold and to resist the efforts of the larger enterprises to gain control over their activities. The general attempt to gain complete control through combinations of enterprises was consequently supplemented by attack through unfair competitive practices aimed at the smaller and less unified organizations. Such an attack was made possible through coöperation and financial backing of the larger unified organizations, and through the inability of the smaller competitors to long withstand the persecutions to which they were subjected. Since the state and federal legislation, crystallizing in the late eighties, was directed against the principles of *monopoly* and *restraint of trade*, necessity for special

legislation to curb the growing prevalence of unfair competition was recognized in 1914, and the Clayton Act was passed by the Federal Congress and a Federal Trade Commission appointed to investigate and repress the evils of unfair competition. The investigations of this commission brought to light a number of methods of stifling competition by unfair means, and resulted in many suits against offenders. These practices have had as their objectives the manipulation of prices, and the use of persecution to drive competitors to the wall or to compel them to come under the control of the monopolist. The Trade Commission found that these objectives were frequently sought in part through:

1. Local price cutting.
2. Secret subsidiaries.
3. Fighting brands.
4. Rebates.
5. Exclusive and restraining contracts.
6. Engrossing.
7. Boycotts and blacklists.
8. Espionage (bribery).
9. Intimidation.
10. Disparagement of competitive products.

Local price cutting.—It would be a mistake to imagine that any effort on the part of the government, whether state or federal, to reduce the evil of this or any other form of competition, is based on pity for the enterprise or enterprises being discriminated against. A more weighty motive is behind curative legislation, the underlying argument being that elimination of competition through price reduction, in amounts which cannot be met by the less efficient or less favored, will eventually result in greatly increased prices by monopoly control of the supply of the product or service.

In actual practice it has been customary for large companies to base their prices in a given locality upon the prices of their nearest competitors, or upon the presence or absence of competition. By destroying competition in this manner prices may be again increased, even to a

point above the price charged when competition began.

This practice has been followed by the old powder combinations, the Standard Oil Company, The National Cash Register Company, and others.

Secret subsidiaries.—This device sometimes designated "bogus competing concerns," has been employed to stifle competition by the companies listed above as cutting prices, and in addition the old American Tobacco Company, the Royal Baking Powder Company, the American Can Company, the Corn Products Refining Company, and others. The practice consisted of secretly organizing manufacturing or selling enterprises, apparently entering the competitive field but in reality being only convenient channels through which to secure access to competitors' secrets. Or, in some cases, they produced and sold an article cheaper than the parent company's standard product, thus meeting and reducing competition without reducing prices on such standard product.

Fighting brands.—The "knocker" machines produced by the National Cash Register Company illustrate this competitive device. This was a machine built and placed on the market by the National Cash Register Company to be offered for sale at a much lower price than the standard product in cases of extreme competition. "Battle Ax Plug," used by the American Tobacco Company, "Kresko" paper supposedly used by the Eastman Kodak Company as a fighting brand, and other fighting brands have been employed.

Rebates.—The classic example of rebating is the practice of the railroads prior to the creation of the Interstate Commerce Commission of 1887. At times the rates of transportation charged the Standard Oil Company by the railroads was little more than half that charged to competitors. In addition it was a frequent practice to give lower rates on oil in tank cars than in barrels, thus giving the Standard Oil Company an advantage, since it owned most of the tank cars. Another practice was to reduce the published rates on oil temporarily, after having given the Standard Oil Company advance information on such reduction, thus enabling them to prepare

large shipments; then to advance the rates again without warning.

The American Sugar Refinery was also accused of taking rebates.

Exclusive and restraining contracts.—These contracts, existing between manufacturer and dealer, contain arrangements requiring (1) that the dealer shall use the manufacturer's product exclusively if at all or (2) that the dealer shall agree to sell the manufacturer's product exclusively or (3) that the dealer shall purchase the manufacturer's product exclusively.

The United Shoe Machinery agreements are examples of the first class, the Continental Tobacco Company, the National Wall Paper Company, and the Eastman Kodak Company being examples of organizations using the latter devices.

Engrossing.—Conversely, it has been common practice for buying concerns to bind the manufacturer to distribute his entire product to the purchaser in order to deprive competitors of the advantages of the use of improved methods through improved machinery. Cigarette manufacturers were accused of engrossing the machinery designed to roll cigarettes more rapidly than it could be done by hand.

Boycotts and blacklists.—This practice consists in circulating lists of dealers to whom goods should not be sold, or lists of dealers to whom sales should be confined. Thus the Lumber Dealers' Association, in 1919, followed a practice by which the association might issue lists of wholesalers or of wholesalers and manufacturers from whom its members might buy. Shipments made directly to consumers by such concerns would, when discovered, be reported to members of the association; and the implication drawn from such reports would be that association members should cease trading with the offending concerns. Such reports also have often contained a list of previous offenders who have been restored to good favor. Generally speaking, this restoration has been conditional upon the payment of a fine by the offending member.

Espionage.—By espionage or bribery it has been pos-

sible for one enterprise to secure valuable information concerning the affairs of competitors. For example, one of the counts against the National Cash Register Company was that it bribed the employees of trucking, express, railway, telephone and telegraph companies to inform it concerning the shipment of consignments by competitors and the receipt of orders from customers and salesmen. Similar accusation has been brought against the United Shoe Machinery Company and others.

Intimidation.—A recent report of the Federal Trade Commission contains an interesting example of intimidation or coercion. It was charged and found by the Commission that the Eastman Kodak Company with the purpose, intention, and effect of stopping the importation of foreign-made film into the United States and eliminating the competition offered by such foreign-made film, acquired the Paragon, G. M., and Sen Jacq laboratories, three fully equipped film-printing and developing laboratories, the combined capacity of which was equal to that of all existing laboratories east of Chicago; that it did not operate said laboratories but held them, fully equipped, as a threat and means of coercing its customers, the film-printing laboratories, into buying their film exclusively from the Eastman Co., to the exclusion of foreign-made film produced by competitors.

Disparagement of Competitive Products.—Some companies have indulged in the practice of disseminating unfavorable reports concerning competitors' products. For example, the Calumet Baking Powder Company was charged in a complaint of the commission with employing the practice of publishing anonymously adverse, disparaging, and derogatory opinions, statements, and comments as to the wholesomeness of self-rising flour, the use of which does not require the addition of baking powder, such statements being not well founded in fact.

Business and Society.

In the immediately preceding chapters attention has been directed to certain sins committed against society by what has been called "big business" and to the devices or

business organization types which have been used to secure and maintain whatever advantages accrue to bigness. It is commonly believed that these conditions are dangerous unless regulated in some manner by the government, but thus far no very adequate or satisfactory scheme of regulation has been devised. On the one hand some attempt has been made to recapture for social benefit portions of the profits of those enterprises enjoying larger incomes, and those such as corporations, which are enjoying special privileges granted by the state. On the other hand, legislation has been enacted through which an attempt has been made to maintain competition despite the natural tendency of business to combine. Apart from government control or regulation, certain corrective measures have been employed within the ranks of industry and business, which have borne some fruit. A brief analysis of these government and private efforts to establish order is made in the following chapter.

Problems.

1. Show how *individual* rights have come to be less important in some respects than *social* rights, in the fields of government, moral issues, and business. Is this tendency increasing or decreasing?
2. (a) Show how monopoly might benefit society. (b) What are its social evils in general?
3. Is monopoly price necessarily a high price?
4. (a) "Larger monopolistic privilege granted by the government must be accompanied by a parallel increase in government control." Is this true? Explain. (b) How does this question tie up with the following chapter?

CHAPTER XXII

SOCIAL CONTROL OF BUSINESS

It has already been demonstrated that the possibilities of evil arising out of governmental creation and toleration of the corporation necessitates a rather rigid check on its activity. These checks are almost universal among the chief incorporating states in the matter of fees, taxes, reports, corporate dissolution in case of violation of charter provisions and liabilities of groups making up the organization. In addition to these checks some states have passed additional curative legislation, business agencies have sought remedial action aside from government regulation, and the federal government has sought to recapture unduly large corporate earnings in the form of taxes to assist society in alleviating the evil of unequal privilege and unequal tax burdens. These federal taxes are:

1. Tax on stock transfers.
2. Tax on inheritance (estate taxes).
3. Tax on excess profits.
4. Tax on undivided surpluses.

These tax requirements merit only brief discussion for the purpose of identification.

Transfer tax.—Two forms of transfer tax are paid to the Federal Government: (a) A stamp tax is levied on the original issue, amounting to five cents per share of \$100 par value. In case of no par value the rate is five cents per share where the actual value per share is \$100. If the total value is in excess of \$100 per share, the tax would be five cents on each \$100 of actual value or fraction thereof, and in case the actual value is less than \$100 per

share the tax amounts to one cent on each \$20 of actual value or fraction thereof.

(b) For subsequent transfers from one owner to another the Federal Government imposes a stamp tax of two cents per share of par value of \$100 or fraction thereof or two cents per share on shares with no par value.

Estate tax.—The federal estate tax law is unlike many of the state inheritance tax laws in that the tax is imposed upon the estate in its entirety rather than upon the distributive shares, and is applied to estates valued in excess of \$50,000. It is the duty of the corporation, usually through the transfer agent, to assume responsibility for the collection of the tax, in the same manner described in connection with the collection of state income taxes.

Excess profits tax.—In 1917 the Federal Revenue Act made provision for tax on excess profits accruing to corporations on account of the sudden increased activity incident to the prosecution of the war by the United States. This tax applied only to corporations having net profits in excess of \$3,000, and began to apply only after the income tax requirements had been met.

Clearly, the enormous surpluses which piled up during the war period could not be attributed entirely to the genius of the enterprisers or holders of stock, but were due in large measure, rather, to the demand by society for consumption goods. In fact, the excess profits tax represents the outstanding example of the adaptation of the social utility theory of taxation as a leveller of income. In as much as the provision was distinctly a war measure, this levy was discontinued in 1921.

Surplus tax.—The surplus tax was less a tax for revenue and more a tool for forcing corporations to distribute their surpluses to the stockholders instead of maintaining them intact to escape the Federal income tax payment. In 1921 the income tax law placed a 12½ per cent tax¹ against the net earnings of corporations while allowing a collection of taxes from individuals running as

¹ Later changed to 13½ per cent.

high as nearly 60 per cent. In order to discourage individuals from incorporating to avoid individual income tax at so high a rate the law further provided for a tax against undivided surpluses of corporations amounting to 25 per cent of the net income where corporations persisted in accumulating enormous surpluses.

As previously indicated, it became common practice on the part of corporations to evade both income and surplus taxes by reduction of the surplus through the use of stock dividends. The law was later revised to omit the provision relating to surplus taxes.

State and Business Control.

At the beginning of this chapter reference was made to efforts made by the states and business organizations to eliminate questionable and fraudulent practices within their boundaries. Reference there was made to:

1. Blue sky laws and better general incorporation laws.
2. Better business bureaus.

Blue sky laws and better general incorporation laws.—In order to sell securities in any state one must comply with the securities statute of the state in which he wishes to do business. These differ widely as to requirements, permits, and tests. Before the advent of state securities laws, the fraud statutes had no provisions against the operation of fraudulent stock and security schemes. "Fly-by-night" promoters took advantage of this loophole and annually swindled the public out of approximately \$500,000,000 as estimated by the Federal Investigation Commission.

The need for such a law was first seen in Kansas in 1911 after citizens had been swindled by fake promotion schemes, and practically every state in the union has followed suit. These laws are known as Blue Sky Laws due to the fact that the assets of corporations promoted were manufactured out of the blue sky, that is, nothing at all.

Some states require the licensing of dealers, some the investigation of the corporations themselves, and some

apply other safeguards. The principal tests used in investigation of securities are:

- a. The character of the corporation (Massachusetts).
- b. The assets and property of the firm (Michigan).
- c. The earning power of the corporation (Illinois, Wisconsin).
- d. The speculative or non-speculative test (Indiana, West Virginia).
- e. The combination of some or all tests.

Different states favor different tests of the value of the securities but most of them consider the character of the corporation, the earnings and the amount of fixed assets.

New York was one of the last states to enact a blue sky law as it was not until 1925 that the Martin Act which is part of the general business law was passed. Provision is here made that any person or corporation wishing to sell securities within the state must publicly proclaim themselves as dealers of such by a notice in the official state paper (which is changed yearly) and must furnish data on all securities to be issued. The notice must contain:

- a. Name of dealer.
- b. Business and post office address.
- c. If a corporation, state in which incorporated.
- d. If a partnership, names of the partners.

The notice at the time of the offering of the issue must contain:

- a. Name and amount of the issue.
- b. Name of corporation issuing it with business address and state of incorporation.

The law also provides the Attorney General with the power of investigation of any security, and by the use of subpoenas or injunctions to require dealers to present themselves or their books in order to investigate their dealings in stocks of a dubious nature. Some securities are exempted from the provisions of this law. They are:

a. Securities guaranteed by the United States, District of Columbia, any state, political subdivision, or agency.

b. Securities guaranteed by any foreign government in diplomatic relation with the United States.

c. Securities listed on the stock exchange on Jan. 1, 1925 and any listed thereafter.

d. Securities of public utility corporations.

e. Securities issued by educational, benevolent, or fraternal organization.

f. Securities issued by any state bank, trust company, or savings institution.

g. Securities that are legal investments for a savings institution.

h. Securities that have not defaulted in the payment of interest or dividends in the preceding five years.

i. Any bonded mortgage sold in undivided whole.

j. Securities sold by any judicial executor, administrator, guardian, receiver or trustee in insolvency and bankruptcy, or any public sale at an advertised auction.

k. Securities sold for pledgee or mortgagee to pay a bona fide debt.

Penalties for violation consist of both fines and imprisonment for offenders with all previous transactions voidable at the option of the purchasers. For refusals to appear or to comply with injunctions there are also penalties.

This statute has succeeded in driving out the dishonest dealers and promoters; is protecting the public from fraudulent securities, and can be said to be generally successful. The chief opposition to the law has been on the points as to whether or not the Attorney General has too much power in dealing with violations and investigations.

The "Seven Sisters" acts.—The attempt at reform in the corporation laws of New Jersey is of more than historical interest since it serves to indicate the difficulty of rigid reform. The movement for reform was begun in 1908 by the appointment of a commission to investigate existing conditions and to report on the need for revision. Nothing was done, however, as a result of the report of

the commission, for it maintained that the existing system was both adequate and legitimate, that it was unwise to revise statutes recklessly, and that the courts in their construction of the laws were conservatively reliable and just in supporting the rights of property and that the law was not lax in its terms, nor in court interpretation.

The question of reform again came before the legislature of New Jersey in 1912 when Governor Woodrow Wilson, in his message to that body, again indicated the deplorable condition of the general incorporation laws. His criticism was directed largely against the possibility of monopoly under the New Jersey laws through the right of domestic corporations to "purchase, hold, assign, and dispose of as it pleases, the securities of this or that corporation and to exercise at pleasure the full right of ownership in them, including the right to vote."

As the result of this message, the legislature passed the "Seven Sisters" laws embodying the following reforms:

- a. Created a strict anti-trust law.
- b. Insisted upon proper valuation of property exchanged for stock.
- c. Prohibited one corporation from holding stock in another, excepting where both were closely related in character.
- d. Prohibited furnishing any commodity or public service at lower rates in one section of the state than in another.
- e. Prohibited the organization or operation of a corporation for restraining trade or creating monopoly.
- f. Prohibited corporations formed by merger or consolidation from holding and voting stock in other corporations.
- g. Prohibited corporations from holding securities in other corporations.
- h. Required the approval by the public utility commissioners of any merger of corporations.

By 1920, however, this great array of reform measures had been removed from the statute books, due in part to

the fact that they had discouraged incorporation in the state of New Jersey to some extent, thus reducing revenues from organization fees and franchise taxes. This experience probably represents the difficulty involved in any attempt to modify conditions which have existed for so long a time and to which people have become so accustomed. It would seem that remedial measures must be introduced more gradually in order that any shock incident to sudden changes may be avoided. This statement is probably true when applied to reform movements in general.

Specific restrictive legislation.—If restraint of trade and monopoly are conceded to be evil, from the standpoint of their effect upon the social welfare, and where unfair competition exists, some control over business activity must be exercised by the government for the purpose of keeping such activity within bounds. The old idea that all these features were essentially bad has gradually been replaced by a liberal application of the "rule of reason," recognizing that some combinations may be advantageous even if some are evil. The problem, then, resolves itself into finding some means by which judgment may be passed upon existing and proposed concentration to determine which are socially good and which socially bad. A review of the efforts to eliminate and to control the evils arising out of the combination movement is given here with little elaborate effort to evaluate each step. These efforts began with a more or less blind, arbitrary regulation, and, like the methods of combination themselves, evolved in more or less clear-cut stages, becoming more scientific and reasonable in their application and interpretation. These regulatory steps were:

1. State anti-trust laws.
2. Federal laws:
 - a. The Sherman Act of 1890.
 - b. The Clayton Act of 1914.
 - c. The Federal Trade Commission, 1914.
 - d. The Webb Act of 1918.

State anti-trust laws.—Most of the states of the Union have either statutory or constitutional provisions embodying the same principles as those contained in the Federal act, the Sherman Anti-trust law to be considered further in a moment, most of the state laws being passed subsequent to the enactment of the Sherman law. These laws, naturally, are designed to cure restraint of trade in connection with business, carried on mainly within the state, while the federal law concerns only interstate trade. As to their application and construction by the courts it may be said that “the statute laws have been very strictly construed regarding restraint of trade. The great majority of the decisions under the laws have been against combinations and contracts in restraint of trade, and against regulation of output, division of territory, and agreements in prices. However, the last set of cases cited shows that contracts restraining trade to a very limited degree have been allowed.

“The statute laws are as strongly against combinations and contracts in restraint of intrastate trade as is the Sherman Anti-trust act for inter-state commerce. Upon the whole, the situation within the states with regard to restraint of trade under the laws and decisions is practically the same as with inter-state commerce under the Sherman act.

“The legislation against the trusts among the states along the same lines as that of Congress shows the influence of contagion, and the willingness of legislators to act upon a generally accepted faith such as that which prevails concerning the power of competition adequately to regulate commerce.

“As already pointed out, combinations in prices, formal or informal, exist everywhere, from the two or three grocers at the country crossroads to the great business concerns. Just as the effect of the Sherman law has been steadily to increase the concentration of industry, so the legislation in the states regarding restraint of trade has been an influence in the same direction.

“The foregoing makes it clear that where a sound and powerful tendency appears which appeals to the common

sense of the community as necessary for the general welfare, a law, however drastic, cannot stand in its way. Burke said in his address upon Conciliation with America, 'I do not know the method of drawing up an indictment against an whole people.' If at the present time the laws against combination in this country are to be strictly enforced, it will be necessary to draw an indictment against the larger part of the business men of the country.

"The great combinations which have been selected for indictment have been those against which popular clamor has been directed. The selection of them has been largely due to this cause combined with their magnitude. Is it not a most unfortunate situation when tens of thousands are guilty, that here and there one is picked out for prosecution?

"One of the most serious evils in connection with the situation arises from this fact. The business men, knowing that coöperation is not possible under the law, are driven to secret understandings and gentlemen's agreements. In the dark, serious abuses appear in connection with coöperation which would not arise if the coöperation were legal and therefore there was no reason to hide the facts from the public. In this respect the business men of England and Germany are in an advantageous position as compared with those of the United States. In those countries they may coöperate; in the United States they may not.

"It would indeed have been fortunate had we allowed the common law to stand, and instead of enacting statutes to prohibit coöperation, had undertaken its control through some administrative instrumentality. While it is believed that the present campaign, by the Attorney-General, to destroy coöperation and return to competition will not be successful, yet if it should be successful, trade, manufacture, and commerce will again be in the position that they were when England and America were under the old restrictions of common and statute law. If it should turn out that business is forced to this situation, we shall again be obliged to go through the same stage

of development that both countries have once undergone, —amelioration of the law until reasonable coöperation is again permissible. In that case we shall, by our unwise attempt through statute law to stem the tide of great economic forces, make America go through two cycles of evolution to reach, permanently, reasonable trade conditions, whereas one cycle has been sufficient for all other civilized countries.”²

The Sherman act of 1890 and the Federal trade commission.—The earlier cases against restraint of trade and monopoly were prosecuted under the common law. But, as has just been seen, the movement toward specific legislation began just prior to 1890 with the passage by state legislatures of anti-trust laws. In 1890 the Federal government took a hand in the restraining movement for controlling those enterprises engaging in interstate trade and violating the anti-trust principles that combinations and trusts were intrinsically evil and should be abolished. This law is commonly known as the Sherman anti-trust act. It may be of great interest to make an analysis of the law and to indicate how modern interpretation and the application of the “rule of reason” have modified its original intent. The law provided that:

a. Every contract or combination in restraint of trade among states or foreign nations was illegal, and the violation of this rule was punishable as a misdemeanor, convicted parties being subject to a fine not exceeding \$5,000 or one year imprisonment or both.

b. The same penalty should be enforced against persons bringing about monopoly.

c. Property in the course of transportation from one state to another owned by persons guilty of violating the restraint-of-trade or monopoly provisions of the law was subject to seizure and condemnation by the federal government.

d. Persons injured in business or property dealings with anyone violating the law might sue in the circuit court of the United States in the district where the de-

² Van Hise, “Concentration and Control,” pp. 200-202.

fendant resided or was found, it being possible to recover three-fold the amount of the damage sustained.

e. Upon application from the Department of Justice, the federal courts were directed to issue injunctions against guilty parties, restraining them from continued indulgence in their monopolistic enterprise.

The Sherman Act embodied a similar weakness to that existing in the Interstate Commerce Act of 1887, regulating the transportation industry, in that the machinery for enforcement was sadly inadequate. The burden of proof, through presentation of evidence, was placed upon the Department of Justice, already overloaded, while the disciplinary action was to be taken by the courts. To remedy this defect, a supplementary law was passed in 1914, creating the Federal Trade Commission, resulting in both changes in method of prosecution and in policies toward persons accused of violating the anti-trust principles.

It may be well at this point to distinguish in a general way between a commission and a court. It has been shown above that the weakness of the court action as it applied to the Sherman Act lay in the absence of executive authority which might interpret the meaning of vague or disputed provisions or to follow the decisions by adequate law enforcement. It is almost impossible for courts to function properly in this respect, because:

1. Courts must be deliberate, and therefore slow.
2. Courts are not equipped to make investigations preliminary to presentation of evidence.
3. The social element involved is lost sight of in an effort to settle the dispute between the contending parties.
4. The court is not in continuous session and is not at all times available for use.
5. Courts are bound down by precedent, and by formalities which are burdensome and awkward.

On the other hand, the administrative commission has the advantage of:

1. Preliminary research facilities.
2. Consideration of social import.

3. Continual availability through continuous sessions.
4. Less formality, greater simplicity and speed, and lower cost per case settled.
5. Lack of necessity for considering precedent and the right to make its own rules for future use.
6. Establishing certainty as to what trade rules are and how they may or may not be observed.

It may now be shown how the above principles operate in the case of the Federal Trade Commission. In the amendatory law of 1914 the collection of evidence against defendants is taken from the hands of the Department of Justice and placed in the hands of a Federal Trade Commission. This commission is appointed by the President, and consists of seven members, holding office for five years, not more than three of which may be chosen from one political party. The law provides further that unfair methods of competition in commerce are declared unlawful. The commission is empowered and directed to prevent persons, partnerships, or corporations, except banks, and common carriers subject to the acts to regulate commerce, from using unfair methods of competition in commerce. The act further states:

Whenever the commission shall have reason to believe that any such person, partnership, or corporation has been or is using any unfair method of competition in commerce, and if it shall appear to the commission that a proceeding by it in respect thereof would be to the interest of the public, it shall issue and serve upon such person, partnership, or corporation a complaint stating its charges in that respect, and containing a notice of a hearing upon a day and at a place therein fixed at least thirty days after the service of said complaint. The person, partnership, or corporation so complained of shall have the right to appear at the place and time so fixed and show cause why an order should not be entered by the commission requiring such person, partnership, or corporation to cease and desist from the violation of the law so charged in said complaint. Any person, partnership, or corporation may make application, and upon good cause shown may be allowed by the commission, to intervene and appear in said proceeding by counsel or in person. The testimony in any such proceeding shall be reduced to writ-

ing and filed in the office of the commission. If upon such hearing the commission shall be of the opinion that the method of competition in question is prohibited by this Act, it shall make a report in writing in which it shall state its findings as to the facts, and shall issue and cause to be served on such person, partnership, or corporation an order requiring such person, partnership, or corporation to cease and desist from using such method of competition. Until a transcript of the record in such hearing shall have been filed in a circuit court of appeals of the United States, as hereinafter provided, the commission may at any time, upon such notice and in such manner as it shall deem proper, modify or set aside, in whole or in part, any report or any order made or issued by it under this section.

If such person, partnership, or corporation fails or neglects to obey such order of the commission while the same is in effect, the commission may apply to the Circuit Court of Appeals of the United States, within any circuit where the method of competition in question was used or where such person, partnership, or corporation resides or carries on business, for the enforcement of its order, and shall certify and file with its application a transcript of the entire record in the proceeding, including all the testimony taken and the report and order of the commission. Upon such filing of the application and transcript the court shall cause notice thereof to be served upon such person, partnership, or corporation and thereupon shall have jurisdiction of the proceeding and of the question determined therein, and shall have power to make and enter upon the pleadings, testimony, and proceedings set forth in such transcript a decree affirming, modifying, or setting aside the order of the commission. The findings of the commission as to the facts, if supported by testimony, shall be conclusive. If either party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for the failure to adduce such evidence in the proceeding before the commission, the court may order such additional evidence to be taken before the commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The commission may modify its findings as to the facts, or make new findings, by reason of the additional evidence so taken, and it shall file such modified or new findings, which, if supported by testimony, shall be conclusive, and its recommendation, if any, for the modification or setting aside of its original order, with the return of such additional evidence.

The judgment and decree of the court shall be final, except that the same shall be subject to review by the Supreme Court upon certiorari as provided in section two hundred and forty of the Judicial Code.

Any party required by such order of the commission to cease from using such method of competition may obtain a review of such order in said circuit court of appeals by filing in the court a written petition praying that the order of the commission be set aside. A copy of such petition shall be forthwith served upon the commission and thereupon the commission forthwith shall certify and file in the court a transcript of the record. Upon the filing of the transcript the court shall have the same jurisdiction to affirm, set aside, or modify the order of the commission as in the case of an application by the commission for the enforcement of its order, and the findings of the commission as to the facts, if supported by testimony, shall in a like manner be conclusive.

The jurisdiction of the circuit court of appeals of the United States to enforce, set aside, or modify orders of the commission shall be exclusive.

Additional powers of the commission.—The law gives the commission additional power:

(a) To gather and compile information concerning, and to investigate from time to time the organization, business, conduct, practices, and management of any corporation engaged in commerce, excepting banks and common carriers subject to the act to regulate commerce, and its relation to other corporations and to individuals, associations, and partnerships.

(b) To require, by general or special orders, corporations engaged in commerce, excepting banks, and common carriers subject to the Act to regulate commerce, or any class of them, or any of them, respectively to file with the commission in such form as the commission may prescribe annual or special, or both annual and special, reports or answers in writing to specific questions, furnishing to the commission such information as it may require as to the organization, business, conduct, practices, management, and relation to other corporations, partnerships, and individuals of the respective corporations filing such reports or answers in writing. Such reports and answers shall be made under oath, or otherwise, as the commission may prescribe, and shall be filed with the commission within such reasonable period

as the commission may prescribe unless additional time be granted in any case by the commission.

(c) Whenever a final decree has been entered against any defendant corporation in any suit brought by the United States to prevent and restrain any violation of the antitrust Acts, to make investigation, upon its own initiative, of the manner in which the decree has been or is being carried out, and upon the application of the Attorney General it shall be its duty to make such investigation. It shall transmit to the Attorney General a report embodying its findings and recommendations as a result of any such investigation, and the report shall be made public in the discretion of the commission.

(d) Upon the direction of the President or either House of Congress to investigate and report the facts relating to any alleged violations of the antitrust Acts by any corporation.

(e) Upon the application of the Attorney General to investigate and make recommendations for the readjustment of the business of any corporation alleged to be violating the antitrust Acts in order that the corporation may thereafter maintain its organization, management, and conduct of business in accordance with law.

(f) To make public from time to time such portions of the information obtained by it hereunder, except trade secrets and names of customers, as it shall deem expedient in the public interest; and to make annual and special reports to Congress and to submit therewith recommendations for additional legislation; and to provide for the publication of its reports and decisions in such form and manner as may be best adapted for public information and use.

(g) From time to time to classify corporations and to make rules and regulations for the purpose of carrying out the provisions of this Act.

(h) To investigate from time to time, trade conditions in and with foreign countries where associations, combinations, or practices of manufacturers, merchants, or traders, or other conditions, may affect the foreign trade of the United States, and to report to Congress thereon, with such recommendations as it deems advisable.

The Clayton act.—During the period in which the Federal Trade Commission law was being constructed considerable difference of opinion arose as to whether or not the act should enumerate specific practices against which it would be directed or should permit the general phrase

of "unfair competition" to be interpreted by the commission and the courts. It has been seen that the latter plan was adopted. A few weeks later Congress passed the Clayton act, including certain anti-trust provisions as to trade unions and industrial concerns. So far as the regulation of industrial or commercial enterprise is concerned the law defines specific acts which are illegal, thus enlarging the scope of previous laws. This definition includes:

1. Price discrimination.
2. Exclusive contracts.
3. Holding companies (in some cases).
4. Interlocking directorates.

Price discrimination.—In this respect it is declared unlawful for persons to directly or indirectly discriminate in price between different purchasers, where the effect of such discrimination may be to substantially lessen competition or tend to create a monopoly. It will be seen that this section may be difficult of enforcement, being subject to interpretation by the Federal Trade Commission or the courts as to what constitutes "substantially lessening competition."

Exclusive contracts.—Section 3 of the Clayton Act prohibits the selling or making contracts for selling goods or for allowing rebates or discounts on goods on condition that the purchaser refrain from dealing in the product of competitive enterprise, when such conduct substantially lessens competition.

Holding companies.—Holding companies are declared illegal excepting where they do not restrain competition. These exceptions are defined as: (1) the purchasing of stock of one corporation by another as a pure investment; (2) intercorporate stockholding among corporations when there is not natural competition; (3) intercorporate stockholding where one corporation forms subsidiaries as natural and legitimate branches of the enterprise; (4) The Webb Act of 1918, discussed in the following section also exempts export companies from the provision of the Clayton Act regarding intercorporate stockholding.

Interlocking directorates.—Section 8 contains a provision prohibiting any person who is a director in one corporation from being, at the same time, a director in any other, where the capital, surplus and undivided profits combined exceed \$1,000,000. This provision has come to mean that only those interlocking directorates which can be classed as in restraint of competition are illegal. Thus the Federal Trade Commission is given wide latitude in determining the degree of this evil.

The Webb act.—The Webb-Pomerene Act of 1918 modified the extreme provisions of the Sherman anti-trust act of 1890 permitting combination in restraint of trade where it concerned itself with export trade only, so that American goods might be sold abroad at prices which would allow competition with foreign manufacturers or combinations of manufacturers. This provision is of relatively little importance since America's foreign trade is almost negligible when compared with her domestic commerce.

Weakness of anti-trust laws.—The original intent of the anti-trust laws was, doubtless, praiseworthy and the method, supposedly, scientific and practical. It must be said, however, that after a decade of functioning, the mechanism for application of the laws, that is, the Federal Trade Commission, lost heavily in prestige and all but lost its powers by threatened repeal of the law providing for its existence. A number of factors have contributed to its depreciation, the principal ones meriting a brief consideration.

In the first place, the number and complexity of the cases investigated and handled, as indicated by the annual reports of the commission, suggest that the organization is inadequate to handle the job for which it was created. As a result the work of the commission is delayed and complaints and reports are inaccurate. Added to this difficulty is the tendency on the part of the courts to reverse decisions made by the commission. The last annual report shows, for example, that the commission was supported by the lower courts twelve times and turned down in twenty-eight cases, while the score stood

7 to 2 against the commission in the matter of appeals. It may be added that even the Supreme Court of the United States has refused the commission access to its files in connection with the prosecution of the tobacco trust prior to the creation of the Trade Commission.

Again, the board, as constituted, must essentially be partisan, and the majority of its personnel shifting from time to time, varying with the fortunes of political parties. Policies and rules of procedure, determinable according to law by the commission, are thus subject to change, an additional factor contributing to the instability of practice in applying anti-trust principles. Thus the law has come to be directed largely to violation of accepted trade practices to the virtual disregard of the original intent, the curbing of movement in restraint of trade or in the direction of monopoly.

This fact, together with the changed policy instituted in 1925 refraining from making public the charges of the commission against the defendant company, led to charges that the commission had become a tool of the big interests and should be abolished. Other minor weaknesses, administrative and legal in character, have arisen but are too involved for consideration here.

Better business bureaus.—The formation of the national Better Business Bureau and of the local bureaus represents an attempt by honest business to suppress unscrupulous business methods, without resort to government or court action. Specifically the Bureau was an outgrowth of long and well laid plans by the National Vigilance Committee of the Associated Advertising Clubs of the World for the purpose of securing universal standards and greater efficiency and coöperation in maintaining truth in advertising. The project became a reality when the organization was incorporated under the laws of Delaware in May, 1925, as the "National Better Business Bureau of the Associated Advertising Clubs of the World." It is now known, however, simply as the "National Better Business Bureau, Inc."

This newly formed organization is a non-profit-making corporation. It has 15 directors and a president,

who have general charge of the work of the Bureau. In addition, provision is made for representing the consumers' group by means of a public relations committee.

Each of the local bureaus is formed and incorporated independently. They are associated with each other and with the National Bureau only in a voluntary and coöperative way and can sever their connections if they wish or can be dropped as members of the association for failure to maintain the standards set by the National Bureau. These same standards and regulations serve as the criteria for admitting new bureaus to the association.

The local bureaus, like the national one, are non-profit making corporations which are financed solely by the voluntary contributions of the investment houses, stores, banks, and manufactories that make up their membership. Nevertheless, the services of the bureau are as freely extended to non-members as to members.

In order to do its work efficiently the National Better Business Bureau is divided into three departments: the Financial, Merchandise, and Education and Research Departments. Each local bureau usually has only the first two of these departments and some have only one, as in the case of the Syracuse Bureau, which maintains only a financial department, although it does render some services along the merchandising line.

Purpose and functions.—The dominating idea of the whole Better Business Bureau movement is to safeguard the interests of the consuming public and to make it possible for honest business to proceed with the least possible competition from fraudulent or questionable business practices.

The function of the National Bureau in its own peculiar field is the work of acting as a clearing house for information received from and desired by the local bureaus. It also has the unique function of handling cases of mail swindles in coöperation with the Federal Government. In addition, it engages in the activities common to the local bureaus. Briefly stated, the duties of the Department of Education of the National Bureau are:

1. To inform the public how to discriminate between legitimate and illegitimate investments and to avoid unnecessary losses through the purchase of misrepresented merchandise or services.

2. To work with representative leaders in the correction of unsound practices or trade customs within business.

3. To gather and analyze evidence of fraud, deceit or misrepresentation, and when wise present this evidence to the proper prosecuting authority, Federal or state.

As a clearing house for information the National Bureau makes it possible for information regarding fraudulent advertising or promotions received from one locality to be quickly distributed over the whole nation. It soon receives replies and clues, compares them, and in a short time can make recommendations, based on a wide variety of facts and sources, for the protection of those concerned in that particular project. From time to time the work which has been accomplished is summarized by the Department of Education and Research and published. For this purpose "Better Business News" is published monthly; and, as occasion demands, special bulletins are sent out for the information of the local bureaus and the protection of the public.

Work of the merchandising department.—The work of the merchandising department of the National and local bureaus is now built around the theory that if a few of the outstanding representatives of a certain line of business can be brought together to formulate what they consider to be fair standards of business methods and advertising in their field, they will themselves stimulate better business methods among their competitors, while the Better Business Bureau will be required to act only as an "umpire." As Edward L. Green, Director of the National Better Business Bureau has put it,³ the purpose of the Bureau is to see that those rules are lived up to by the whole group.

³ *Printer's Ink Monthly*, June, 1926, pp. 33-34.

Where it is not practicable to pursue just this method a plan is followed which is in substance as follows:

1. A collection of samples of advertising in the field to be studied is made in order to give a fair prospectus and idea of the most common abuses.

2. This collection is analyzed and a digest made of what appears to be false or misleading.

3. Reports are obtained from shoppers on their experiences with advertising and selling methods.

4. An analysis and brief of these shoppers' reports is made.

5. The brief of the shoppers' reports is compared with the digest of advertising practices in order to see how these practices are reflected by the buying public.

6. Dealers, advertising managers, and buyers are interviewed to ascertain what practices they think are wrong.

7. On the basis of the above findings, recommendations are made considering (a) material factors, (b) trade practices, and (c) public opinion.

8. These recommendations are reviewed by a small cross section committee.

9. The recommendations are submitted at a meeting of dealers.

10. Publicity of the recommendations is secured.

11. Steps are taken to see that the recommendations are carried out.

12. Information is developed to force out deceptive advertising.

13. If offenders persist in violating the recommendations, either giving publicity to their methods and names, or prosecution, is resorted to, depending upon which method is considered as being the more effective.

Following the plan given above, recommendations have been prepared for several lines of business. For example, definite standards have been set up for the advertising and selling of correspondence school courses, furniture, radios, mattresses, cotton goods, and imperfect articles of clothing. Campaigns, such as the "Name the Woods" campaign in the furniture and radio industries, have been

directed against specific misleading practices in an attempt to do away with them and to secure nationwide approval and adoption of fair methods. This particular campaign mentioned above has received the hearty approval and endorsement of Federal Government officials who have also coöperated in trying to make it effective and successful.

The Better Business Bureau acts on individual complaints received by it; or, when necessary, it sends out one or more of its own representatives to buy merchandise, which it believes to have been unfairly or fraudulently advertised, in order to obtain evidence. If misrepresentation is thus discovered, the Better Business Bureau first notifies the offender and seeks to have him mend his ways; but, if he persists, it takes steps to have the facts published or to have the offender prosecuted. The real object of the bureaus is not so much, however, to prosecute or to censor advertising as it is, in the words of Mr. Buckley, vice-president of the Chicago bureau, "to correct the misrepresentation that goes on after advertising has brought people into a store to buy."⁴

One weapon which has often been effectively used against misleading advertising is the securing of the co-operation from newspapers in having them refuse to accept or print such advertisements in their pages. Conversely, the Oakland, California, bureau has given advertisers advice concerning fraudulent advertising mediums.

The work of the financial department.—The Financial Department, proceeding with the slogans, "Before You Invest—Investigate" and "Read Before You Sign" has carried on a vigorous campaign against all forms of fraudulent and unsound financial ventures with the object of preventing losses from those sources to individual investors and of diverting that money into safe and legitimate business enterprise. From this purely economic viewpoint alone the work has seemed of sufficient importance to many financial institutions to contribute freely to this phase of the bureaus' work.

⁴ *Printer's Ink*, August 26, 1926, p. 140.

In general the method pursued by this department is to secure publicity in the papers and through its members to inform the public as to what it is trying to do and to offer its services free for these purposes. As inquiries or complaints are received from individual prospective investors or investment institutions a record is made on a blank similar to the one that appears on the following page.

When these blanks are filled out, they are filed by the bureau, and information regarding the case is gathered by local investigation or by writing to the National Bureau or to other local bureaus. As fast as this information is received, it is filed under its particular case number and is cross-indexed both as to the name of the inquirer and the name or aliases of the subject of the inquiry. When the data thus collected seems sufficient, a careful comparison and analysis is made of all the findings. If these are insufficient for drawing a conclusion, an effort is made to obtain more information, until it can be definitely determined whether or not the proposition under investigation is sound. Such findings are then given to the person requesting the information and may also be published, if it is a matter of concern to the community at large. Furthermore, if the matter is of more than local interest, the findings will be reported to the National Bureau or to the local bureaus directly concerned or affected. Sometimes, also, individual warnings will be sent out, as in the case of the Great Basin Oil Company of Holbrook, Arizona, which had been active in trying to interest professional men of various localities in their scheme. The Syracuse bureau mailed letters to individuals giving them some of the facts about the company which showed its precarious nature and concluding as follows:

Further information upon this corporation is available at the office of this bureau.

“BEFORE YOU INVEST———INVESTIGATE”

If the advertising of an investigated project proves to be misleading, an attempt is made to remedy conditions

INQUIRY RECORD

Date _____ 192

Subject of Inquiry

Business

Address

— Merchandise Section

— Investors' Section

— Complaint — By Telephone Received by _____

— Inquiry — In Person

Received from _____

Remarks :

Action taken :

at the source without resorting to legal action. But in case results cannot be obtained in that way, the information is handed over to the proper authorities for prosecution. In fact some of the bureaus have in their organization regular deputies to the state's Attorney General, who handles such cases.

The bureaus are very careful to have sufficient accurate evidence before they seek to institute an action; consequently, good results have generally been obtained. In Detroit, for example, the bureau has been commended for its helpfulness and efficiency in outlining for the Attorney General the defensive arguments likely to be met in such prosecutions and in supplying facts to meet those arguments in individual cases.⁵ Investigation of the reports of local bureaus shows that failure to secure conviction is rare. Sometimes counter actions are brought against the bureaus for libel; but so far they have not succeeded because the bureaus have been careful not to publish anything they could not back with evidence and facts and because the courts are generally in sympathy with the Better Business Bureaus in the work they are trying to do. The New York City bureau has published in a pamphlet entitled "Law Enforcement" a report of what it has accomplished in this respect from August 1 to October 31, 1926; and it publishes other reports in the papers from time to time.

Obstacles to the bureau's work.—The greatest apparent evil which is directly attributable to the corporate form of business enterprise is the ease with which even a worthless proposition can be incorporated in some states at almost no expense to its promoters, who can then sell its securities where they please. If they are excluded from one territory, they go to another; and when the project becomes too dangerous, they simply drop it and start another somewhere else, since being served with an injunction is about the worst thing that ever happens to them. In this connection, it is interesting to note that a large number of the cases tried on the grounds of fraudu-

⁵ *Printer's Ink*, September 30, 1926, p. 109.

lent and criminal practices in promotions often involve men who have been tried, or even convicted, before—some of them several times. This seems to indicate a weakness in the legal and judicial system of dealing with this evil, since old offenders seem to get off altogether, or to escape with mere fines or short sentences, later resuming their crooked work. Thus, the better business bureaus try to accomplish by publicity and pressure what cannot be done by any system of laws or courts.

Yet another difficulty the bureaus have to overcome is the seemingly perverse obstinacy or gullibility of large numbers of people who hand over their money credulously and recklessly to glib strangers rather than seek the advice of reputable business men and bankers or avail themselves of the free service of the Better Business Bureaus to protect themselves against such loss.

Summary.—Perhaps the best summary which can be given of the work and purpose of the Better Business Bureaus is in the words of H. J. Kenner, general manager of the New York City Bureau, in a talk on "Better Business Bureau Policies," at a meeting of Better Business Bureau executives in Detroit, September, 1926, in which he said:

"A Better Business Bureau's purpose is to increase public confidence in the printed and spoken word of business and to reduce unfair competition.

"It acts on its own facts, disinterestedly.

"It examines both sides of a question fairly.

"It deals in information, not opinions; it avoids controversies.

"It strives to be constructive and it is not censorious.

"It endeavors to change the point of view of an erring business man by friendly contact with him; to turn even an unscrupulous man into one who deals fairly.

"It helps to lower selling costs by reducing the causes of resistance to legitimate sales efforts.

"It renders illegitimate methods unprofitable by constructively making them a matter of wider public knowledge.

“It works to the public interest for the advantage of business as a whole.

“It does not grind private axes for business or for members of the public.

“It deals with non-members as fairly as with members; it is as considerate of the small business man as of the big one.

“It is fearless without being fanatical and it places principle above expediency in any situation.”

Size of the task confronted.—Because of the very nature of the situation, of course, figures are not to be had as to just how much money is lost in unsound promotions and diverted from useful economic channels; but estimates by financial experts, such as Roger Babson, place the probable annual loss from worthless securities sold in this country at a minimum of a billion dollars, and many of them believe that the figure is more likely many times that amount. But the worst of it is that the loss from this source seems to be increasing annually.

Since the very aim and nature of the Better Business Bureau is prevention, and since the extent of such fraudulent activities cannot be accurately measured and is often quite unknown, it is impossible to say in just what degree the Better Business Bureaus have succeeded in safeguarding the public from loss in investments and in increasing the public's confidence in advertising. The only indication of results which can be found is the opinion of some of the men who have been in touch with the Better Business Bureaus' work and a few isolated facts concerning the number of cases investigated, the number of convictions secured, specific cases of changing the views and tactics of offenders, statutes whose passage and enforcement have been secured, and other similar results of a more or less tangible nature.

Just a few of these items picked more or less at random may serve to give an idea as to the nature of the work being accomplished. For instance, the National bureau is reported to have received and answered 1,200 inquiries between August 1 and October 31, 1926; and

in the same period the Merchandise Department investigated over 500 cases of advertising and issued 1,000 service reports to retail members. Even the newly formed Syracuse bureau, operating in a city of only 200,000 is already handling about 250 inquiries a month. An article in the New York Times, dated March 9, 1926, recounts the work of the Better Business Bureau in its effort to keep the stock of the Idaho Copper Corporation from the Boston Curb Market and to frustrate the efforts of Charles Ponzi in his famous Florida real estate frauds which became the subject of Federal Government action because of fraudulent use of the mails in connection with them.

A report on the New York City bureau over a short period of time shows one thousand cases of alleged misrepresentation in retail selling investigated, inaccuracy in naming of goods in advertising reduced from 26% to 3%, improvement in naming of pelts; corps of shoppers sent out to obtain evidence and chemical analyses made of their purchases. Upon the basis of these shopping trips reports were issued weekly to members.

Some idea of the extent of the work of the Better Business Bureaus may be gained from the fact that local bureaus are maintained in 48 of the largest cities in the United States and representatives are kept in many other localities. From another standpoint its importance can be estimated from the fact that about 15,000 business institutions participate in the movement.

Problems.

1. How would the socialist probably control business?
2. Show what would be gained or lost through such a system of business control.
3. Why are public utilities, railroads, and certain of the professions subject to greater government control than other common forms of business?
4. What is the difference between socialism and anarchy? Why may this question be raised here?

CHAPTER XXIII

THE CHANGING ATTITUDE TOWARD "BIG BUSINESS"

General movement.—Despite the efforts of the government to check the movement toward concentration of capital in productive and distributive enterprise in the interests of social well-being, combination goes steadily forward. And while they recognize the need for continued public protection, government agencies and popular sentiment seem to have come to the point of recognizing the necessity for toleration of the combination movement, permitting it where economy and convenience demand it, while prohibiting it where the result seems to be harmful to society. While it may be impossible or unwise to attempt isolation of all the reasons for this changing attitude, or the characteristics of the movement toward concentration, certain observations may be presented in this chapter with relative safety.

What are the evidences of a changing attitude toward combination? A few illustrations, taken from American history since the Great War, will at least partially answer this question. The Webb act of 1918, modifying the Sherman Act to permit combinations for the purpose of competing with foreign countries in the matter of foreign trade, has already been cited. The reversal of opinion in the matter of combination in the transportation industry, as evidenced by the Transportation Act of 1920 is a second case in point. Another excellent illustration is afforded by Secretary Jardine's declaration of October, 1925, concerning the Armour-Morris combination in which he declared it legal by dismissing Secretary of Agriculture Wallace's complaint against the combina-

tion.¹ The complaint was instituted in February, 1923, shortly after the Armour Company had taken over the properties and good-will of the Morris Company, and raised the point that the purchases tended toward the creation of a monopoly in violation of the Packers and Stockyards Act. Secretary Jardine in his answer to the complaint decided that "the purchase by one competitor of the physical properties, business and good-will of another company is not in express terms condemned by this statute." He found no evidence of any intent in this particular case to manipulate prices or create a monopoly, but "on the contrary, the evidence is persuasive that it was for the purpose of effecting economies in the conduct of the Armour respondent's business by reducing overhead expenses and increasing the volume of sales of the finished products." He further pointed out that the new merger controlled less than 25 per cent of the packing business which was still less than that controlled by the Swift Company, a strong competitor. Thus, by combining, Armour would be in a better position to compete with Swift.

It is not necessarily true, however, that the government is readily lining itself up with the combinations formed against the letter of the anti-trust acts. In fact, the government recently forbade the formation of the "bread trust" project by the General Baking Corporation, the Ward Baking Company, the Ward Food Products Corporation, the Continental Baking Corporation, and the United States Bakeries, on the ground that it would tend to create a monopoly.

On February 9, 1925, the Commission was directed by the Senate to investigate the American and Imperial Tobacco Companies for two sets of facts: (a) the various inter-relations of the above mentioned concerns and (b) the methods used by these companies in opposing and boycotting the farmers' coöperative marketing associations. It is obvious that the government, appreciating the present-day economic conditions leading up to the

¹ *Congressional Record*, 68 Cong., 2nd Sess., Vol. 64, p. 3666.

consolidation movement, and with due respect to the anti-trust acts, shows liberality in application of the rule of reason in distinguishing the good and bad features of business life, although it has not formulated definite policies to meet this popular appeal in other lines of industries than those already mentioned in previous chapters. When the rule of reason is applied, the bad must be prohibited and the good must be encouraged.

The point is best illustrated by the "Nickel Plate" case in March, 1926. The proposed merger had for its object combination of the Nickel Plate Railroad, controlled by the Van Sweringen Brothers of Cleveland, with the Erie, Pere Marquette, and Chesapeake and Ohio, together worth more than a billion dollars with 9,000 miles of main track and an annual earning of \$60,000,000. The Interstate Commerce Commission rejected the plan on March 3, 1926, on the ground of an unsatisfactory financing plan. The commission held that the provision for exchange of securities by the component stockholders for stocks in the new company violated the rights of the minority who were opposing the merger, chiefly in the case of the Chesapeake and Ohio, and that active voice had been denied these minority stockholders. But a way was open to the Van Sweringens to modify their financial plan for the approval of the project. This is significant and points out clearly that the government, realizing the value to public interest of such a merger, did not object to the principle of combination, but rather to the undesirable methods of bringing about that particular combination plan.

Characteristics of present movement—universality.—Examination may now be made of some of the important characteristics of the present-day combination movement. First of all, emphasis must be placed on the widespread and universal nature of the movement when we examine the large number of cases. They are not only large in number, but they are also divergent in lines of industries. Recent years have witnessed mergers or proposed mergers in railroads, industrials, banks, and public utilities. This makes a strong contrast with the ten-

dencies of former periods when a few branches of industry, most noticeably steel and oil, were prominent in the consolidation movement.

Among the railroads, the Nickel Plate plan is most noted. The "Frisco-Rock Island plan" contemplated a merger of the Rock Island and St. Louis and San Francisco railroads which would form the largest single system in the world in mileage, with combined assets of almost a billion. The disapproval by the Commission of the Nickel Plate, instead of halting the trend of combination in railroads, had the opposite effect on other roads contemplating combination. The Loree system in the Southwest, embracing the Kansas City Southern, Missouri-Kansas-Texas, and the St. Louis-Southwestern railroads likewise considered combination. Other plans began to take form in the South and the East, and only time will show how far the movement is to go in this field of industry.

There are many cases of mergers or proposed mergers in industrials. The National Food Product Corporation in the baking industry and the Armour and Morris case in the meat packing industry are typical. In the extractive enterprises, considerable attention was attracted by the announcement of the Standard Oil Company of Indiana acquiring control of the Pan-American Petroleum Company. Then appeared the so-called Standard Oil Company of New York-Magnolia Petroleum Company of Texas merger, and a great deal of interest has been focused on the proposed merger of the Pacific Oil Company with the Standard Oil of California. Among other mergers in the field of industrials, is the Eastern Dairies, Inc., manufacturing ice cream and allied products in New England.

Mergers among financial institutions have proceeded more rapidly in England and on the Continent than in the United States. This is due to the fact that financing foreign trade is of much greater importance there than here. However, world competition has brought about several notable mergers in the United States, particularly in New York City. For example, in February, 1926, the

Mechanics and Metals National Bank merged with the Chase National Bank. In October of the same year the Irving Bank and Trust Company, the American Exchange Bank, and the Pacific National Bank united to form the American Exchange-Irving Trust Company. A number of other mergers might be cited. Only the future will indicate the degree to which this movement will extend, or what proportions the Federal Government will permit it to assume.

The combination movement has been going on for some time among the public utility groups so that it is unnecessary to trace the development in this field. Probably the newest proposals among public utilities have to do with a number of projects to merge certain chains of hydro-electric properties, doing business in a number of different states, into some sort of concentrated ownership and management.

Combinations not monopolistic in purpose.—The second characteristic of the present-day consolidation movement is that no attempt is made, at least in a large proportion of the new enterprises, to consolidate all or most of the plants in a given industry, regardless of whether they are high or low grade. As a rule, a new plan of consolidation is to select only the efficient plants for the combination. A good example is the packers' merger, which is made up of the "Big Five" in the industry. The same thing is true of the bakery and banking mergers. (This reference of course is to the banks and industrials only, the railroads and some of the public utilities belonging to a different category). If further facts will not contradict this generalization of the situation it may be safely inferred that the motive of combination to-day is not for monopoly, as the new enterprises do not attempt to get complete or majority control of plants in a given industry. What a contrast with the Whiskey Trust, which acquired most of the distilleries in the industry and, operating only a small proportion of the efficient and well-situated plants, shut down the remainder in order to get complete or majority control of plants in a given hand when a selection of plants for combination is made

on the basis of efficiency, the motive, if rightly inferred, is combination for efficiency of operation and cutting down of overhead. Competition being predominant, this would enable the combination, representing a comparatively small part of the industry, to compete more effectively with others in the market. It would therefore seem that modern industry has at least discovered a sound economic basis on which to conduct its business and meet competition. The principle is efficiency rather than the artificial condition of monopoly.

The federal administration has come to be somewhat tolerant toward this movement, as has been pointed out. In fact, it has been criticized by some as being under the influence of Wall Street and of maintaining "weak-kneed" policies, and of trying to avoid attacks on trusts or preferring not to interfere except in flagrant cases. There has been no sentiment either way expressed in recent political platforms. The press seems divided in opinion on the subject. Some fear the potentiality of monopoly, but many cherish high hopes for this new development of the nation's business. One newspaper suggests that, "to those familiar with the greater latitude being given to 'big business' under the present administration, the merger does not come as a surprise. The day of 'trust-busting' is past. The pendulum has swung in the other direction, and mergers of all kinds, railroads, bakeries, packers, etc., are being encouraged." Those who favor the new movement hold that economy of production, management, and distribution under a combination is better than that under single small concerns. Therefore, the movement works for the good of the public—the consumer—in the form of lower prices and better quality of product.

Public tolerance toward combination.—In the third place there has come to be a tolerant sentiment on the part of the public in favor of "big business" where in earlier years the monster "trust" was a much dreaded thing. Some explain this change by the statement that the American public, with its craze for things big, is used to big organizations of business and would not feel at

home without them. Being cautious of the superficiality of such a reason it is still possible that truth is not lacking in it. Two additional reasons for this change may be suggested:

- (1) Changed ethics in business;
- (2) Diffusion of ownership.

Reasons for public tolerance—Changed ethics.—Business men claim that there has been a decided change of business ethics within the last few years. Instead of the iron law of supply and demand, we have found a new conception of human values; instead of brutal competitions, we have realized the lesson of fair play in business. Possibly no one has expressed this change in business morality more forcefully than the late Judge Gary, promoter and former chairman of the United States Steel Corporation:

“It has been my privilege to witness a radical change in the mental attitude on the part of the men who conduct big business. . . . We may safely conclude that the conception of moral duty in business has greatly altered, especially in its bearings upon relations of the public, and organization of business. . . . When I first came to New York and undertook the problems growing out of the Steel Combination I encountered a code of practice that has almost disappeared. . . . The managers of some large institutions apparently believed that so long as their conduct came within the strict, technical rules of law it was immune from public or private attack. With them the conception of moral duty did not extend beyond the belief that if no provision of public law was violated, a corporation should be permitted to earn unlimited profits and might treat indifferently its customers, employees, competitors and even the body politic as a whole. . . . The Golden Rule received no thought and had no place in the practice of that school and period. Competition was tyrannical and destructive. Weaker competitors were forced to quit business as big combinations arose, sometimes by means not only unethical, but brutal as well. The graves of insolvents were strewn along the path

of industrial developments. Finally the strong grew richer and stronger. Instead of competition existing as the life of trade, a very necessary element of progress, it was made the instrument of death in trade. Instead of monopoly being destroyed, it was thus encouraged. Instead of preventing increased combination of capital, such combinations were brought into being by the pressure of destructive competition. . . . The welfare of the typical workman was decided almost entirely from the standpoint of utility and profit.

"But I believe none of these purely material reasons led to a change for the better. On the contrary, I believe we improved our methods when we obtained a new glimpse, a finer conception of ethics. . . . Having admitted, perhaps emphasized, the delinquencies of business in the other days, it becomes interesting for us to examine conditions to-day. Certainly it is disturbing that many fair-minded men and women should be incredulous when they hear it maintained that the ethics of business has reached a high plane. (But it was for so many years that ethics had no place in business that we hardly should be surprised to find a part of the public still holding such a view.) . . . Operations are conducted under a stricter rule of ethics than before. . . . It may be asserted with the fullest confidence that in the period of which I write, business has undergone a moral overhauling without precedent. To my personal knowledge many men of big affairs have completely changed their opinions and methods concerning ethical questions in business. . . . Men who once believed that the subjects of ethics in business had little bearing upon their conduct, now assert that a proper code is the controlling element. The majority of business men conduct operations on the basis that right is superior to might; that morality is on a par with legality and observance of both is an essential to worthy achievement. They regard employees as associates, and partners instead of servants. Executives have come to understand that stockholders are entitled to a reasonable share of information so that under no circumstances can there be

preferential rights or opportunities. At last it has been perceived—and this belief is spreading everywhere—that destructive competition must give way to humane competition; that the Golden Rule is not an empty phrase, but a golden principle. Finally, business as a whole sees that full and prompt publicity of all facts involving that public weal, not only must be made possible, but must be insisted upon as a primary tenet of good faith.”²

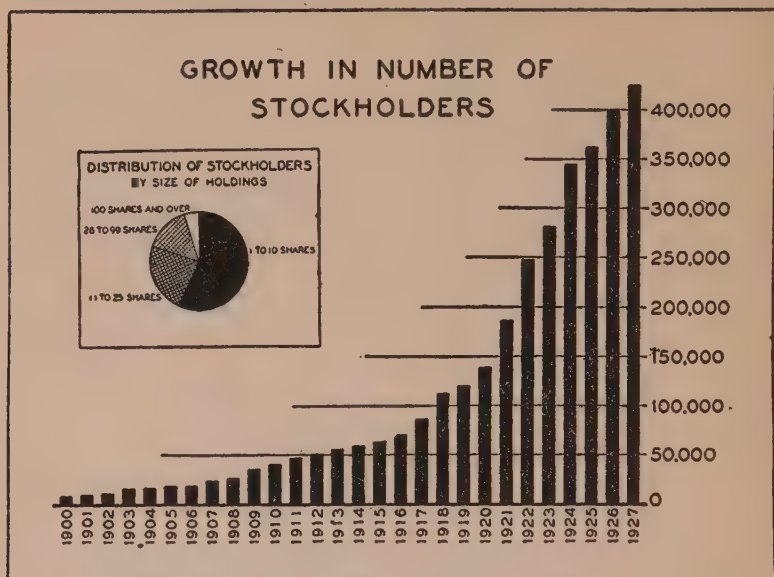
True, modern business men do not do business for altruistic purposes. But the old rule of honesty is indeed a golden one, and the results of integrity may be finally measured in dollars and cents. With this change of ethical standard and under the rigid restriction of law, the old methods of operation and competition have indeed changed for the better. To the public, big business has become more humane and natural and less war-like than before. Indeed, these tremendous organizations and smooth working systems have even come to be admired by the members of society.

Public attitude and diffusion of ownership.—The second reason for the changed attitude lies in the diffusion of corporate ownership in the hands of the public. Most of the big corporations in the United States to-day are owned by the public through stock holding; this presents a vivid contrast to former conditions when most of these huge capitalistic enterprises were held in the hands of a powerful few or within a family circle. The tendency to wide-spread corporate ownership by the general public in all lines of industry in the country must be recognized. Of all the large corporations, the American Telephone and Telegraph Company takes the lead in the largest number of persons financially interested in the system. This is because of the corporation's nation-wide scale of development and increasing need of new capital.

The chart on page 328, showing the degree of growth in numbers of stockholders of the American Telephone and Telegraph Company between 1900 and 1927, is significant:

² *Current History*, Vol. XXIII, No. 6, pp. 775-779.

AMERICAN TELEPHONE AND TELEGRAPH COMPANY



The number of stockholders of this company increased from 7,535 in 1900 to 423,580 at the end of 1927. During 1927 the increase was 24,459. Of the total stockholders at the end of the year, 57 per cent were holding only from one to ten shares each, as indicated in the small insert above. More than 75,000 stockholders were employees of the Bell system who, for the most part, had bought their stock by small monthly payments under the employees' stock plan.

There were also, at the end of 1927, approximately 26,000 holders of common stock and 150,000 holders of preferred stock of the associated companies. Making allowance for duplication in these totals, it is estimated that there were more than 525,000 owners of stock in the Bell system.¹

A similar trend is noted in the electric light industry. Between 1914 and 1927 the increase in ownership of stock in the companies affiliated with the National Electric Light Association amounted to almost one million, with a

¹ Annual Report, American Telephone and Telegraph Co., 1927.

par value of stock amounting to \$8,000,000. The annual increase after the war was nearly ten times the annual increase from 1914 to 1918. Studies in other industries reveal similar tendencies.

Several generalizations may be made from the above analysis concerning the tendencies of ownership in industry in this country. In the first place, it is obvious that ownership is to-day being diffused into the hands of the general public, as contrasted with former periods when the powerful few controlled most of the nation's industry. In the second place, the policy of the different industries is to encourage their employees to purchase their stock, so that as a result, in the third place, there is an increasing proportion of employee ownership of securities. These tendencies are normal ones, being out-growths of the increasing demand for new capital and the parallel increase in earnings and savings among the employee class.

Mr. Robert S. Binkerd, Vice-President of the Committee on Public Relations of the Eastern Railroads, submitted the following data after a comparative study into the stock-ownership of the railroads, public utility companies, and certain industries as of January 1, 1918, and of January 1, 1925:

NUMBER OF STOCKHOLDERS

INDUSTRIES	1918	1925
Railroads	647,689	966,170
Express and Pullman	12,956	23,779
Total Railroads and Allied Service	660,645	989,949
Street Railways	275,000	500,000
Gas, Electric Light & Power	1,250,000	2,611,279
Telephone and Telegraph	107,033	371,604
Packers	65,000	100,000
Ten Oil Companies	23,502	161,179
Five Iron & Steel Corporations	130,923	223,149
Ten High-Grade Mis. Mfg. & Dis. Companies.....	25,002	44,339
Totals	2,537,105	5,051,499

Within the period of seven years, 1918-1925, the number of stockholders of the different industries shows an

increase of 2,514,394, the number being practically doubled. According to the report, of this increased number, 338,760 were employees of the industries, 864,754 regular customers, and 1,310,880 were of the general public.

Twenty-six class I railroads representing about 60 per cent of the main-line mileage of the whole country show an increase of 70,262 in the number of employee stockholders, and 45,003 in the number of customer stockholders. The stockholders of the railways have increased in 7 years, but only a small number of the increase represents the employees and customers. The packers show an increase in stockholders of 35,000, with 7,000 coming from the employees, making the total employee stockholders to date not less than 20,000.

Ten oil companies, representing more than ten per cent of the production of the oil industry, show an increase nearly seven times. This increase comes mostly from the general investing public. These companies include some of the Standard Oil group and a number of the independent companies operating in different parts of the country. The bulk of the employee stockholders are to be found in the Standard Oil Company.

Five steel companies, representing about 70 per cent of the steel industry, show an increase from 130,923 stockholders to 223,149. This group shows a large participation by employee interests, the figure amounting to 87,696.

The last group includes high grade industries such as boots, shoes, clothing, typewriters, automobiles, mail-order houses, and department stores. They show an increase of almost 100 per cent within a period of seven years. A small proportion of this increase came from employee customers, but it is difficult to ascertain the exact proportion.

In most of these concerns, plans are formulated whereby employees may acquire the securities of the respective industries. In the analysis made above, it is probable that the employee interests are underestimated, since the bulk of the securities sold to them are purchased on the installment plan, payments ranging from twenty-one

months to five years. The names of the employee stockholders usually do not appear on the stock record books until their stock is fully paid for. Obviously, these names are beyond the reach of the investigators.

With the development of these conditions, the time for considering the big corporations and "big business" as unassimilable elements has gone by. As a result, the prejudice against the accumulation and concentration of wealth and capitalistic enterprise as menaces to public interest is being gradually broken down because ownership of these enterprises by the powerful few is gradually being shared with those who are intimately concerned, the employees and customers. This is probably the strongest weapon which the corporations could have used in their defense against social prejudice and opposition.

Summary.—An attempt has been made in this book to explain the nature of the great variety of types of business enterprise and to account for the existence of such a variety. It has been shown that the simple types owe their variety to attempts to adjust their contractual relationships in ways which would permit of large accumulation of capital funds by means of reduction of risk to investors. At one end of the list stands the individual entrepreneurship and at the other, the corporation. Intermediate forms complete the list.

Having made available large capital funds, chiefly through the use of the corporation, the next step in the development of business forms consists in the adjustment of relationships between competing organizations in order to secure the advantages of concentration or large scale production. In explaining the great variety of inter-relationship types of enterprise, reference has been made to the need of replacing one form with another on account of the inadequacy of the first, or because of social control through government regulation. Starting with agreements and pools, the final instruments of concentration came to be the holding company and complete consolidation. These last types are tolerated through a public sentiment which has, apparently, changed, and an ap-

plication of "the rule of reason" on the part of the courts. Efforts are now made to permit society to benefit from the economic virtues of concentration, at the same time protecting it from any resulting evils. Thus, less importance is attached to mere *form* of the enterprise, and more attention is given to the *intent*, as it affects the social well-being.

Problems.

1. Write a brief summary of the changing attitude toward "big business."
2. Are there any evidences that there is *not* a changing attitude as indicated in this chapter?
3. Explain, by way of review, why we have so large a variety of types of business enterprise.

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Business enterprise, structure

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WITHDRAWN

	Date Due		
MAR 20 '47			
APR 6 '52			
OC 6 '52			
OC 8 '52			
OC 15 '52			
MAY 10 '53			
MY 14 '55			
MY 25 '63			
FE 13 '69			
MY 16 '80pd			
MY 13 '77			
2-6-86			
4-7-87			
JA 06 '89			
AP 20 '90			
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Types of Business Enterprise

